Office of the Under Secretary of Defense (Comptroller) (OUSD(C))

How to Prepare for an Audit of Environmental Liabilities Course

Student Guide

Version 1.0 **October 2005**

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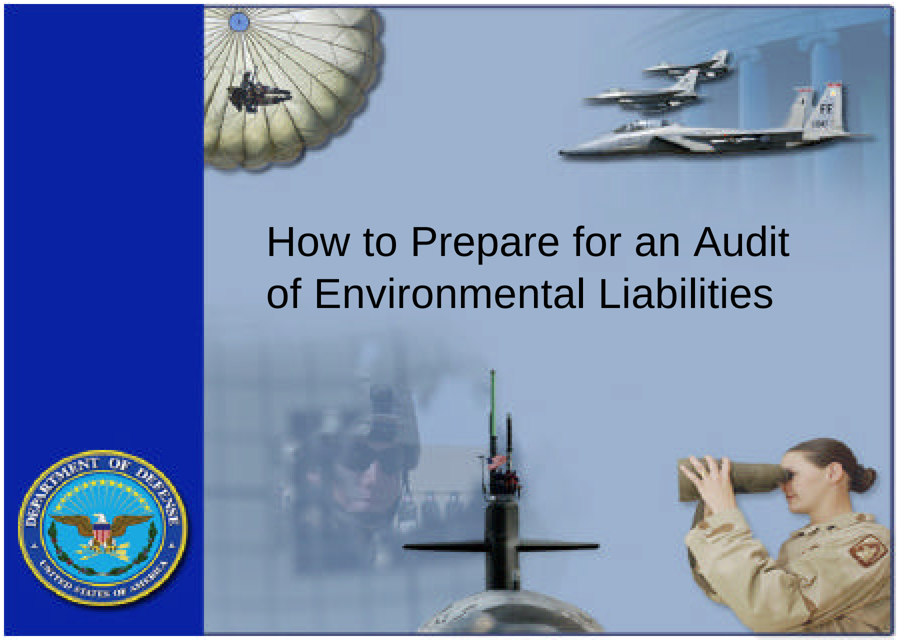
Course Title	**How to Prepare for an Audit of Environmental Liabilities**
Course Identification	Course Code: OSD-EL Course Type: F
Level and Type	Introductory Functional Course
Course Length	8 hours 8 CPE credit hours
Field of Study	Accounting and Audit, Government Accounting and Reporting – Specialized.
Course Description	The How to Prepare for an Audit of Environmental Liabilities course, Version 1.0, is an eight-hour, introductory functional course designed to help students identify and analyze components of environmental liabilities on the DoD financial statements; document transactions and engineering estimates for environmental liabilities; value environmental liabilities; describe key legislative and regulatory requirements and guidance for supporting documentation; and describe how tools help achieve audit compliance. The course concludes by examining the assertion process.
Learning Objectives	Upon completion of this course, the student will be able to: • analyze components of environmental liabilities on the DoD financial statements • describe how to document environmental liabilities • describe how available tools help achieve audit compliance.
Presentation Mode	The primary methods of instruction are conference, questions, discussion, and a final examination.

Who Should Attend	The audience for this course includes all individuals who require an understanding of the complexities surrounding environmental liabilities in relation to the financial statements audits. It will be composed of civilian and military personnel of various grades and ranks in positions of both financial and non-financial responsibilities.
Prerequisites	There are no prerequisites for this course.

Table of Contents

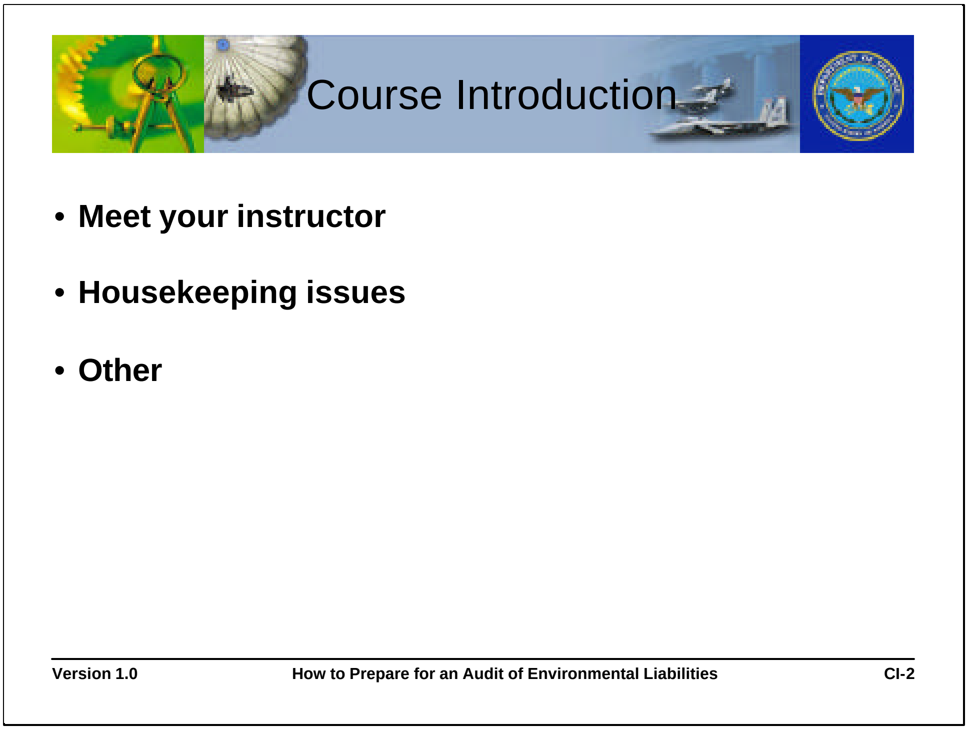


Good morning and welcome to the How to Prepare for an Audit of Environmental Liabilities course.

The 2004 Performance and Accountability Report (PAR) indicated environmental liabilities are a weakness on the financial statements because of insufficient guidance and audit trails. It went on to state that the inventory of ranges and operational activities, such as landfills and open burning pits, is incomplete. The first step in solving this problem is understanding it.

This course is presented in three lessons and designed to help you understand how to prepare for an audit of environmental liabilities to help solve this problem.

But before we get into more in-depth information, let's discuss some important points.



Since we are going to be together all day, I would like to start by introducing myself. I am ______________ and …..(name, background, and what makes you uniquely qualified to instruct this course).

Now let’s talk about a few general housekeeping topics.

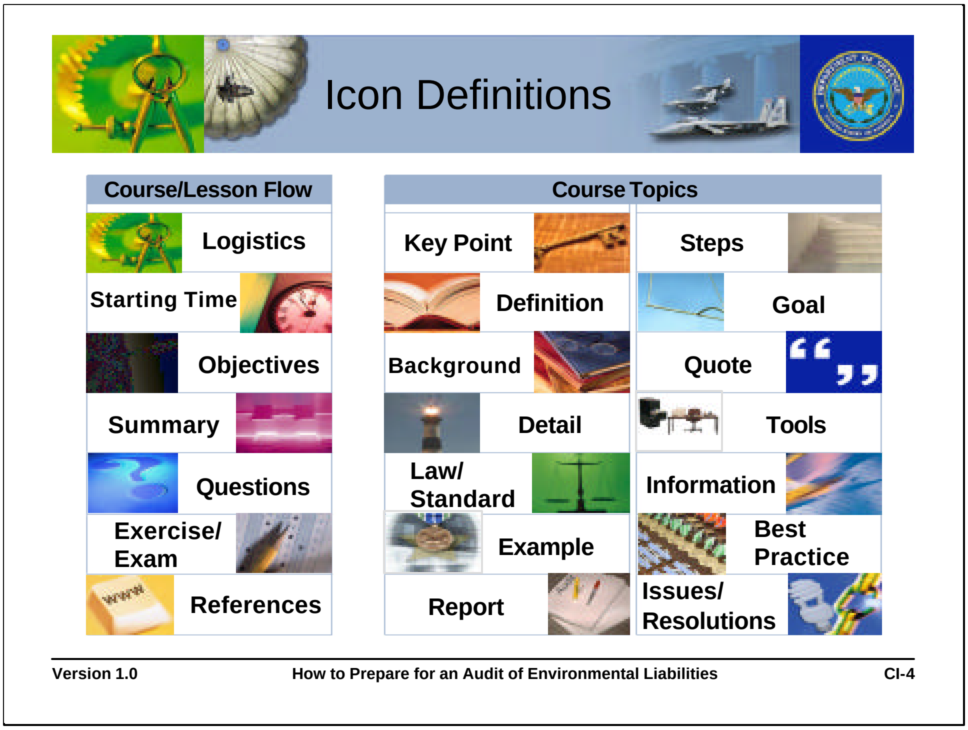
Restrooms are located at _______, and break facilities, coffee, and snacks are located at _______. Drinks and snacks are not allowed in the classroom.

Please silence all pagers and cell phones, and refrain from their use while in the classroom. If you must stay in contact, please leave the room to answer a silent page. Telephones for your use are located at _______.

During this discussion, you will be provided with examples of financial transactions and other proprietary information either from the instruction or from your classmates. You must assume that this information is not for use by the general public, nor is it to be published or disseminated to third parties.

The format for this class is conference/lecture and will include questions and discussion. There are no practice exercises, but there is a final examination. You may use any materials provided in the course or discussion to complete the examination.

Let's take a look at these materials.

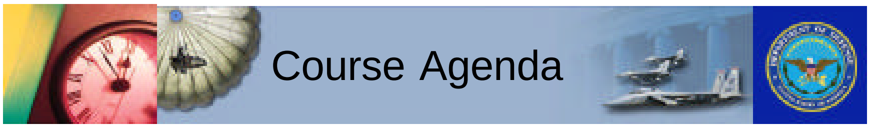


Notice that each page is formatted with a header. The left corner of each header contains an icon that provides a visual key to the contents of the page. For example, this page displays the Logistics icon.

The main icons describe course and lesson objectives and introduce key topics. Additional icons within each topic represent definitions, background information, and issues and resolutions. Best Practice and Lessons Learned icons will show examples of successful practices implemented by the government or industry. At the conclusion of each lesson, icons will represent the lesson summary, questions and answers, final examination, and links to references available for more information.

Please feel free to take notes on your student materials, and to write down any questions that you have that we may not have had time to address during the discussion of a particular topic. Your questions are very important to us, but we may not have the answer or sufficient time available in the classroom and may have to go to an outside source for an answer.

Now let's examine the course agenda.



Time	Title
8:00 - 8:10	Introduction
8:10 - 10:45	Lesson 1, Identifying Critical Components of Environmental Liabilities
10:45 - 12:00	Lesson 2, Documenting Transactions for Environmental Liabilities
12:00 - 1:00	Lunch
1:00 - 1:40	Lesson 2, Documenting Transactions for Environmental Liabilities (cont.)
1:40 - 3:30	Lesson 3, Using Tools to Prepare for Audits of Environmental Liabilities
3:30 - 3:40	End-of-Course Review
3:40 - 4:30	Final Examination
4:30 - 5:00	Course Critique

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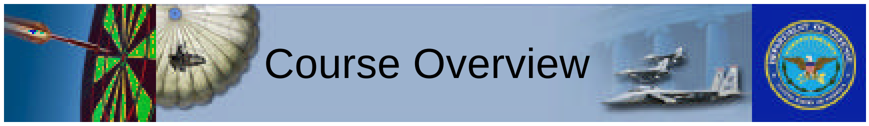
This is our road map for the day.

Class starts promptly at 8:00 a.m. and will break for ten minutes each hour.

Lunch is scheduled from 12:00 to 1:00 and the course ends at 5:00 p.m.

In this course, there are three lessons, an end-of-course review, and a final examination. Lesson 1 will be completed before lunch, and Lessons 2 and 3 will be completed after lunch. Finally, you will complete a course critique and the instructor will distribute the course completion certificates.

Let’s discuss the purpose and objectives for this course.



This course is designed to teach you how to prepare for an audit of environmental liabilities.

This is important because audits of the annual financial statements have shown that the Department is materially deficient with regard to the documentation needed to support environmental liability transactions.

This course is designed to teach you how to prepare for an audit of environmental liabilities.

We will examine several specific aspects of what is needed to facilitate proper documentation and accountability of environmental liability transactions.

However, notice the mention of "materially deficient" in the second paragraph. This means the lack of supporting documentation is preventing auditors from being able to assess whether the Department's financial statements are accurate or not. We must be able to provide evidence of cost estimates, including all supporting documentation, in order to meet the challenge.

We will talk more about this as the course continues, but first let's look at the course objectives.

Upon successful completion of this course, you will be able to:

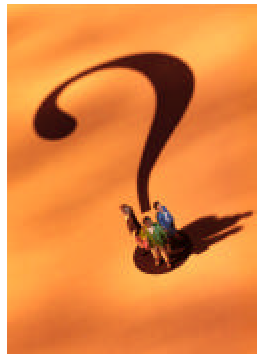
- **Analyze components of environmental liabilities on the Department of Defense (DoD) financial statements**
- **Describe how to document and properly account for environmental liabilities**
- **Describe how available tools assist in achieving audit compliance**

This course will enable you to analyze components of environmental liabilities on the Department of Defense (DoD) financial statements including the Balance Sheet and Note 14.

It will identify and describe the different types of supporting documentation for environmental liability transactions. This documentation is important and must be available to support the financial statements audits and provide a clear audit trail for auditors.

Finally, the course will describe how available tools, such as checklists, help achieve audit compliance.

Questions



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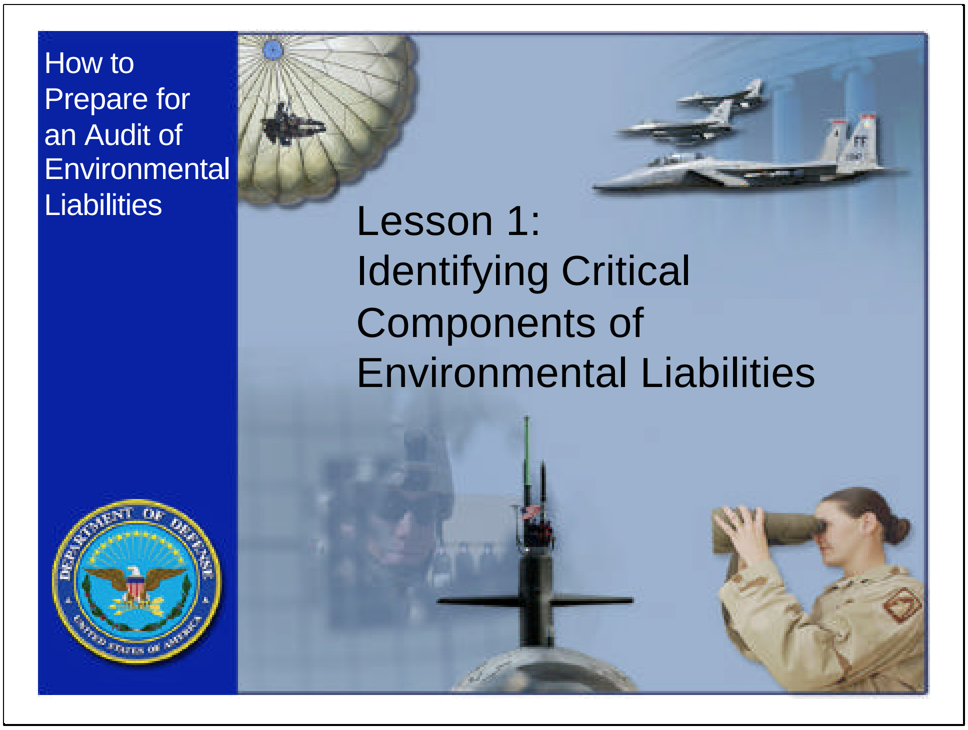
Before we proceed with Lesson 1, Identifying Critical Components of Environmental Liabilities, are there any questions?

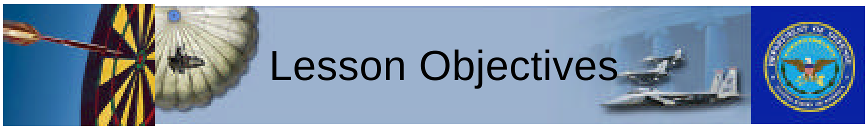


In Lesson 1, we explore the critical components of environmental liabilities in order to help you become better prepared to receive an unqualified opinion on your annually audited financial statements. You might ask, "Why are we doing audits?"

The Chief Financial Officers (CFO) Act and the Government Management Reform Act (GMRA) require that our financial statements are complete, accurate, and auditable. Congress and the taxpayers are requiring more out of the dollars provided to us, and financial statement audits are one means to see if we are complying.

The bottom line is the same for us as any private company. For example, would you invest your money in a company that can't achieve an unqualified opinion on an audit of their financial statements? Probably not, and it's that lack of confidence that our shareholders feel. We must do better.

Let's discuss the lesson objectives.



Upon successful completion of this lesson, you will be able to:

- **Describe statutory and regulatory requirements for supporting documentation**
- **Explain how to recognize and report environmental liabilities**
- **Describe how to account for environmental liabilities**

This lesson will teach you to recognize environmental liabilities as differentiated from other types of liabilities. It stresses the reporting requirements for environmental liabilities and examines how to account for them.

This lesson will also review the laws and directives necessary for you to understand the supporting documentation that is required to support the audit trail of environmental liability transactions.

This is important because recent audit findings continue to show weaknesses in the Department's supporting documentation including those associated with environmental liabilities.

This lesson contains the following topics:

- **Legal and Regulatory Requirements**
- **Environmental Liabilities**
- **Proof of Statements and Checklist Integrity**
- **Defense Environmental Restoration Program (DERP)**
- **Non-DERP Liabilities and Their Impact**
- **Internal Control**
- **General Ledger Accountability of Environmental Liabilities**

In this lesson we discuss the critical components of environmental liabilities. We begin by examining the definition of environmental liability followed by a discussion of proof of statements, that is, comparing the financial statements with applicable detailed notes.

Our discussion of checklist integrity illustrates the integrity of the annual financial statements with emphasis on the Balance Sheet.

The Defense Environmental Restoration Program (DERP) and non-DERP liabilities are examined with special emphasis on their impact on the financial statements.

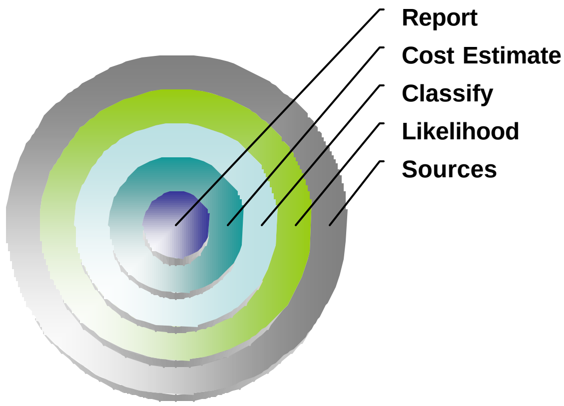
We will talk about some of the accounting related issues relative to environmental liabilities and we discuss the various internal controls that must be in place to ensure the accuracy of reported environmental liabilities and finally the laws, departmental regulations, and policy and guidance established by the governing boards.

I mentioned the CFO Act and GMRA a moment ago. Through these, Congress mandated that we annually produce auditable financial statements. This requirement is not going to go away, so we must comply. In addition to the legislative push for increased accountability, it just makes good business management sense. Funding requests are much more defensible when the numbers have been validated through audit.

Let’s begin with an overview of environmental liabilities requirements.

Legal and Regulatory Requirements

Environmental Liabilities Overview



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This graphic depicts the key steps that lead to financial statement reporting of environmental liabilities. From sources outside the DoD to the those within the Department, events occur that require operational controls be implemented to comply with environment, safety, and occupational health legal, regulatory, policy and performance requirements. We then classify the environmental liability by Balance Sheet classification.

We then collect the information needed to determine if the likely outflow of future resources is probable, possible, or remote and if the cost can be reasonably estimated. The costs are then classified according to the Balance Sheet classifications which we will discuss later in the course.

The potential future actions to include proposed remedy, associated costs, and schedules that are necessary to correct, restore, remediate, or close a facility or site due to environmental concerns is quantified in cost estimates. This leads back to where I started, that is, Balance Sheet reporting.

These reporting requirements are based on legal and regulatory requirements that we will explore next.

Legal and Regulatory Requirements

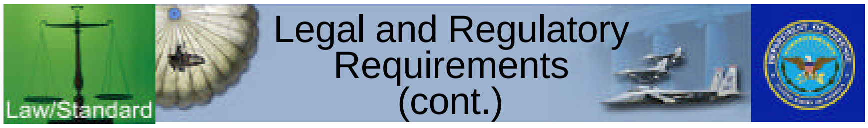
Key Legislation

- **Chief Financial Officers Act (CFO Act)**
- **Government Performance and Results Act (GPRA)**
- **Government Management Reform Act (GMRA)**
- **Federal Managers Financial Integrity Act (FMFIA)**
- **Federal Financial Management Improvement Act (FFMIA)**

These are key legislation that affect environmental liabilities, as they pertain to the financial statements.

If you could lump them together and pull a couple of important key points from them, you might say collectively that they require the federal government to report liabilities in the annual financial statements, and that those statements must be auditable. Each of the legislative acts has placed increased emphasis on accountability at the lowest level. Environmental liabilities are an important part of the Department's overall reporting that requires strict adherence to these key legislation.

Let's explore them further.



Legal and Regulatory Requirements (cont.)

Chief Financial Officers Act

- **Mandates a five-year financial management plan**
- **Requires annually audited financial statements**
- **Transfers much of the standard-setting authority from the GAO to the OMB**
- **Established the Chief Financial Officers**
- **Provides for increased agency accountability**

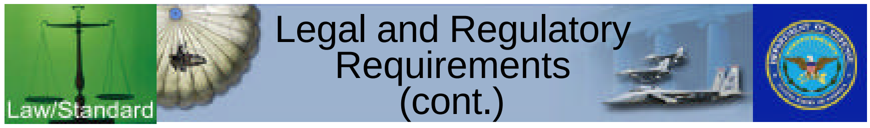
The CFO Act requires that the government annually produce a Federal Financial Management Status Report and Five-Year Plan. It also requires that federal agencies annually prepare auditable financial statements. This was the first such requirement in federal history and posed some challenges to the federal participants.

For example, consolidated auditable financial statements must be produced from the Department's 19 subordinate financial statements reporting entities. As of FY 2004, only seven of the 19 entities received a favorable audit opinion on their financial statements.

The Act also transferred authority to the Executive Branch to help modernize the government's financial systems and emphasized financial reporting at every level. Each Agency was required to establish the position of Chief Financial Officer to provide a sound management link to the OMB's financial management responsibilities.

Overall, the Act provided for increased accountability by promoting increase responsibility at the lowest level. This means that environmental liabilities are not only the responsibility of the financial community, but also the responsibility of those who develop estimates and maintain supporting documentation.

The next slide, we look at more Congressional intent regarding the implementation of the CFO Act.



Legal and Regulatory Requirements (cont.)

The Congressional intent of the CFO Act is to improve:

- **Information for management**
- **Financial management systems and accounting data**
- **Accountability and measure performance**
- **Internal control**
- **Communications**
- **Cost savings and efficiencies**
- **Uniform accounting standards**

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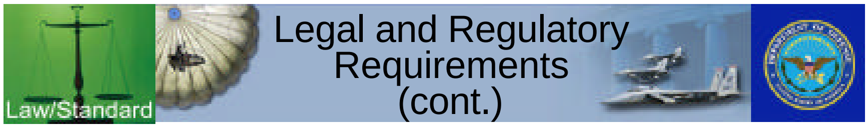
With the underlying goal to provide federal leadership with quality information in order to make better decisions, the CFO Act leads toward improvement in financial management systems and internal control aimed to negate waste, fraud, and abuse of resources. This includes that related to environmental liabilities. The intent of the Act includes accurate environmental liability information that management can act on.

These enhancements help ensure the production of complete, reliable, timely, and consistent financial information for use by the executive and legislative branches in the financing, management, and evaluation of programs.

The activities that are performed in compliance with the CFO Act contribute to the Department's ability to produce audited financial statements that receive an unqualified opinion. An unqualified audit opinion also provides Congress and the senior Department leadership with a level of assurance in the validity and integrity of the financial data.

The GPRA is discussed next.



Government Performance and Results Act (GPRA)

- **Requires agencies to develop strategic plans, set performance goals, and report annually**
- **Intent of the act is to improve public confidence by holding agencies accountable**

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The GPRA strengthens the CFO Act by requiring agencies to develop strategic plans, set performance goals, and report annually on actual performance as compared to the those goals. The intent of GPRA is to improve public confidence by holding agencies accountable to achieve program results and to improve congressional decision making by clarifying and stating program performance goals, measures, and costs up front.

For GPRA to be successful, it depends on leadership that can link decision-making authority to accountability, create incentives, build expertise, and integrate management reforms.

The GMRA is discussed next.

The objectives of the GMRA are to improve the effectiveness of financial management reporting and require all federal agencies to submit audited financial statements. The GMRA expanded the CFO Act to apply to the 24 major Agencies and their Components, and required the federal government to consolidate all agency financial statements into a single set of audited financial statements.

Collectively, these and other items of legislation form the basis for the audit of environmental liabilities. They establish the legal framework from which directives, policies, and regulations are derived. That said, the purposes of performing financial statements audits include providing decision makers or financial statements users with assurance that the financial statements are reliable, internal control is effective, and laws and regulations are complied with.

Let’s look at Generally Accepted Auditing Standards (GAAS).

Legal and Regulatory Requirements (cont.)

Generally Accepted Auditing Standards (GAAS) require auditors to give an opinion following an audit that classifies the results as:

- **Unqualified opinion – conform to Generally Accepted Accounting Principles (GAAP)**
- **Qualified opinion – conform as above, except for the matter that makes the exception**
- **Adverse opinion – does not conform to GAAP**
- **Disclaimer opinion – appropriate when there is a lack of independence, scope limitations, or doubt, about the organization's ability to survive, and for uncertainties like insufficient evidential matter**

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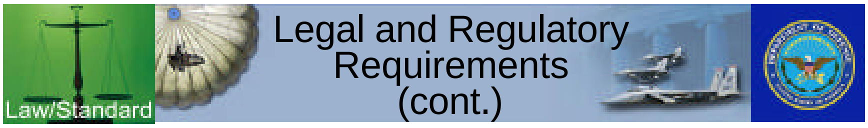
The opinions given to audits of financial statements are related to GAAS. The Department received a disclaimer on its 2004 audit, which means that there is more work needed. Let's take a quick look at terms so we are clear on what a disclaimer means.

- Unqualified Audit Opinion – The financial statements present an entity's financial position in conformity with GAAP.
- Qualified Audit Opinion – Except for the matter to which the qualification relates, the financial statements are in conformity with GAAP. For example, there may be a lack of evidential matter, restrictions on the scope of the audit, or the auditor believes that the financial statements contain a departure from GAAP, the effect of which is material.
- Adverse Opinion – The financial statements do not present the entities' position in conformity with GAAP.
- Disclaimer Audit Opinion – This opinion indicates a lack of independence. There are scope limitations (inability to obtain sufficient competent evidential matter) when the auditor concludes that there is substantial doubt about the entity's ability to survive (going-concern), and for matters involving uncertainties. Uncertainties may arise when there isn't enough evidential matter to support an event.

Now let's talk about the FMFIA.



Legal and Regulatory Requirements (cont.)

Federal Managers Financial Integrity Act (FMFIA)

- **Obligations and costs are in compliance with applicable laws**
- **Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation**
- **Revenues and expenditures, applicable to agency operations, are properly recorded and accounted for**

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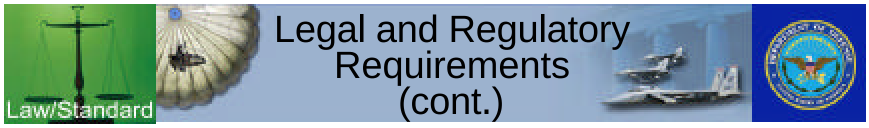
The FMFIA amended the Accounting and Auditing Act to require ongoing evaluations and reports of the adequacy of the systems of internal accounting and administrative control of each executive agency.

The amendment added a new subsection to ensure compliance with the requirements regarding obligations and cost; funds, property, and other assets are safeguarded; and revenues and expenditures are properly recorded and accounted for to permit reliable reporting of assets.

Let’s discuss the FFMIA.



Legal and Regulatory Requirements (cont.)

Federal Financial Management Improvement Act (FFMIA)

- **Implement and maintain financial systems that comply with federal financial management systems requirements, applicable federal accounting standards, and United States Government Standard General Ledger (USSGL) at the transaction level**
- **Determine the compliance of systems and a business case before investment in information technology**

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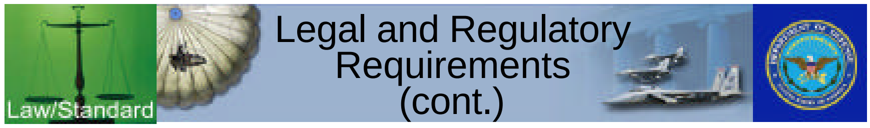
The FFMIA builds upon and complements the CFO Act and the GMRA. The legislation speaks to the form and content of the financial information produced by federal agencies. It also addresses the system or process used in the production of this information.

Earlier we discussed general ledger accountability and reviewed some of the GLAs used to properly account for environmental liabilities. In part, the FFMIA is responsible for the accuracy of accounting information because it requires federal financial management systems to use the USSGL at the transaction level. By mandating conformity in the use of accounts, the FFMIA helps ensure the integrity of recognized environmental liabilities. It's easy to see the importance of application of the United States Government Standard General Ledger (USSGL) when considering the Department's consolidated financial statements. Each Agency must comply with the FFMIA or the integrity of the statements decline with each role up.

Next we discuss the Federal Accounting Standards Advisory Board (FASAB).



Legal and Regulatory Requirements (cont.)

The Federal Accounting Standards Advisory Board (FASAB) is the standards-setting body for federal government entities.

Statements of Federal Financial Accounting Standards (SFFAS):

- **Establish federal GAAP**
- **GAAP language communicates outside government**
- **Helps determine government's accountability, efficiency, and effectiveness**

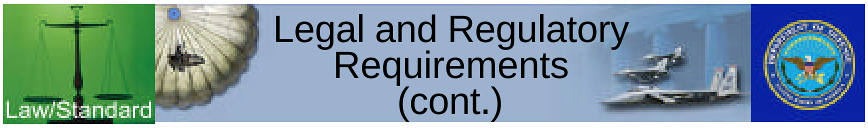
The FASAB issues SFFAS, Interpretations, and Technical Bulletins.

The CFO Act requires audited financial statements in accordance with applicable standards. The FASAB was established to develop federal accounting standards for financial statements therefore fulfilling the law. The Board includes the Secretary of the Treasury, the Director of the OMB, and the Comptroller General who develop standards for the financial statements. The SFFAS issued by the FASAB are designed to implement GAAP.

The federal accounting standards issued by the FASAB, are the SFFAS. The SFFAS play a major role in fulfilling the government's duty to be publicly accountable along with the Interpretations. Two of the SFFAS are applicable to environmental liabilities; they are SFFAS No. 5, and it's amendment SFFAS No. 12, as well as SFFAS No. 6. Upon request, the Board issues Interpretations to clarify, implement, endorse, or otherwise facilitate officially established accounting principles.

Sometimes it takes a while for the SFFAS to be issued, as they may require extensive due process, including appointing task forces and holding public hearings. So the FASAB uses Technical Bulletins to provide timely guidance. The Technical Bulletins are issued to provide guidance on certain financial accounting and reporting problems of any federal financial reporting entity. Their website has a form to communicate technical inquiries related to accounting by entities of the federal government, and they normally respond in one to two days.

The key reporting guidance is discussed next.



Key Reporting Guidance

- **Management Guidance for DERP – September 2001**
- **DoDFMR, 7000.14-R, Volume 4, Chapters 13 and 14 (being combined)**
- **DoD OUSD Acquisition Technology and Logistics (AT&L) Management Guidance for Recognizing, Measuring, and Reporting Non-DERP Environmental Disposal and Closure Liabilities – May 2005**

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The premier guidance for DERP is found in the memorandum on this subject dated September 28, 2001. The guidance contains current information on the implementation of DERP and should a constant reference for those who work this area of liabilities.

The DoDFMR consists of 15 volumes and contains general financial information on budgeting, accounting policy, disbursing policy, reporting policy, Military pay, civilian pay, travel policy, contract policy, reimbursement operations, special accounts, non-appropriated funds, financial management education and training, and security assistance policy and procedures. Volume 4, Chapters 13 and 14 are currently in draft development to be replaced with a single combined chapter that has been submitted for coordination.

Likewise, the non-DERP guidance is also being coordinated. The draft guidance used in this course can assist you in your work and should be referenced by those who work this area of liabilities.

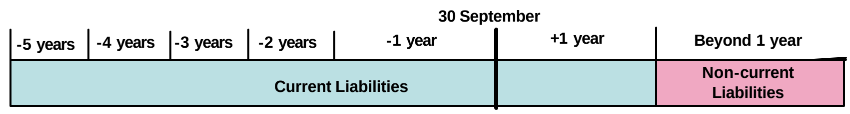
Now let's discuss environmental liabilities, beginning with a brief understanding of what a liability is in general.

Liability: an amount owed for items or services received and expenses incurred.

Liability recognition is *not* based on the availability of funds.

Categories of liability:

- **Current Liability – will be paid in the next 12 months**
- **Non-current Liability – will not be paid in the next 12 months**
- **Contingent Liability – condition, situation, or circumstance involving uncertainty, where the uncertainty will be resolved in the future when one or more events occur or fail to occur**



Timeline of Current and Non-current Liabilities

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Liabilities are a normal aspect of conducting business. Rarely does a transaction occur that is liquidated on the spot as takes place in a cash or barter transaction. Instead, one party provides goods or services in exchange for a promise of payment in the future. The liability must be recorded, even if funds are not available. If that payment is likely to take place within the next 12 months, we say it is a current liability. If that payment is more likely to take place beyond the next 12 months, then we say it is a non-current liability. Current liabilities include those from the preceding five years that will be paid in the next 12 months.

When a condition, situation, or set of circumstances exist that involve uncertainty regarding a possible gain or loss, it is called a contingent liability. This uncertainty is resolved in the future when either something happens or an outcome is determined. The difficulty with contingent liabilities is determining their probability of occurrence and deriving an estimate of their costs. These two factors, probability of occurrence and the ability to estimate the expected cost, determine whether the contingent liability should be recorded and reported as a liability or disclosed as a contingency in Note 16 on the financial statements. For more details on recognizing contingent liabilities, refer to the Department of Defense Financial Management Regulation (DoDFMR), Volume 4, Chapter 12, paragraphs 120303 through 120305, and the Statement of Federal Financial Accounting Standards (SFFAS), Numbers 5 and 12.

Let examine the topic of contingent liability more closely.

Environmental Liabilities (cont.)

Liabilities are classified as:

- **Probable – chance of occurrence is likely (more likely than not)**
- **Reasonably possible – more than remote, but less than probable**
- **Remote – chance of occurrence is slight**

Contingent liabilities become recognized liabilities when:

- **Event or exchange transaction has occurred**
- **Future outflow is probable**
- **Future outflow is estimable**

	Reasonably Estimable	Not Reasonably Estimable
Probable	Liability is measured and recognized in Note 14 and the Balance Sheet	Contingency is disclosed in Note 16 to the Balance Sheet
Reasonably Possible	Contingency is disclosed in Note 16 to the Balance Sheet	Contingency is disclosed in Note 16 to the Balance Sheet
Remote	Not disclosed	Not disclosed

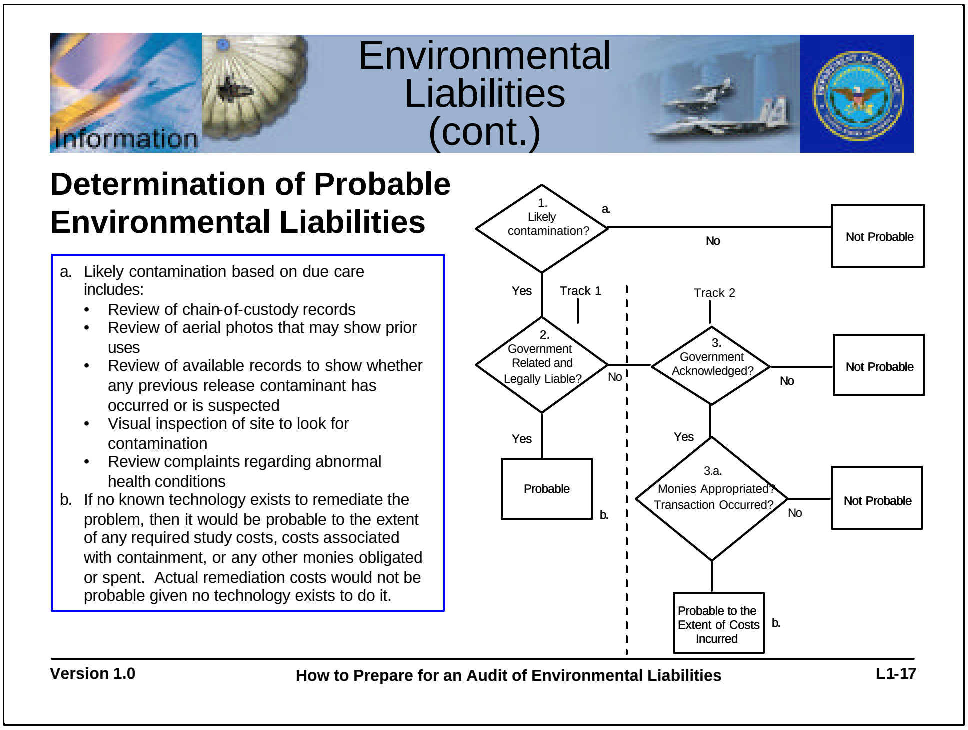
An environmental contingent liability should be disclosed in Note 16 of the financial statements, if any of the conditions for liability recognition are not met but there is a reasonable possibility that a loss or additional loss was incurred.

Version 1.0 How to Prepare for an Audit of Environmental Liabilities L1-16

Here we examine the circumstances under which a cost is classified as a contingent liability or a liability. In order to recognize a liability, it must be probable and measurable. Probable means the event is more likely than not to occur. An exception to this rule regarding contingent liabilities states that to recognize losses on matters of pending litigation and unasserted claims, a future payment must only be likely rather than more likely than not to occur. When there is at least a reasonable possibility that a loss or additional loss occurred, the liability must be disclosed in the financial statements footnotes.

On the slide, we can think of the surety of the liability as moving from the bottom right to the upper left. For example, when the chance of occurrence is remote and it is not reasonably estimable, no action is required relative to the financial statements. As we move up toward the top left corner, we see the event is probable and reasonably estimable. This liability is recognized in the financial statements. For more information regarding "probable" and "reasonably estimable," refer to SFFAS 5 and Federal Financial Accounting and Auditing Technical Release #2.

The focus of this course is on the green box, or those events that create an actual liability. Next, we review the importance of gaining legal advice in the determination of whether a contingent liability exists or not.



To be a probable liability, the first step, shown as Number 1 on the chart, asks to decide if there is likely contamination based on due care. Due care includes:

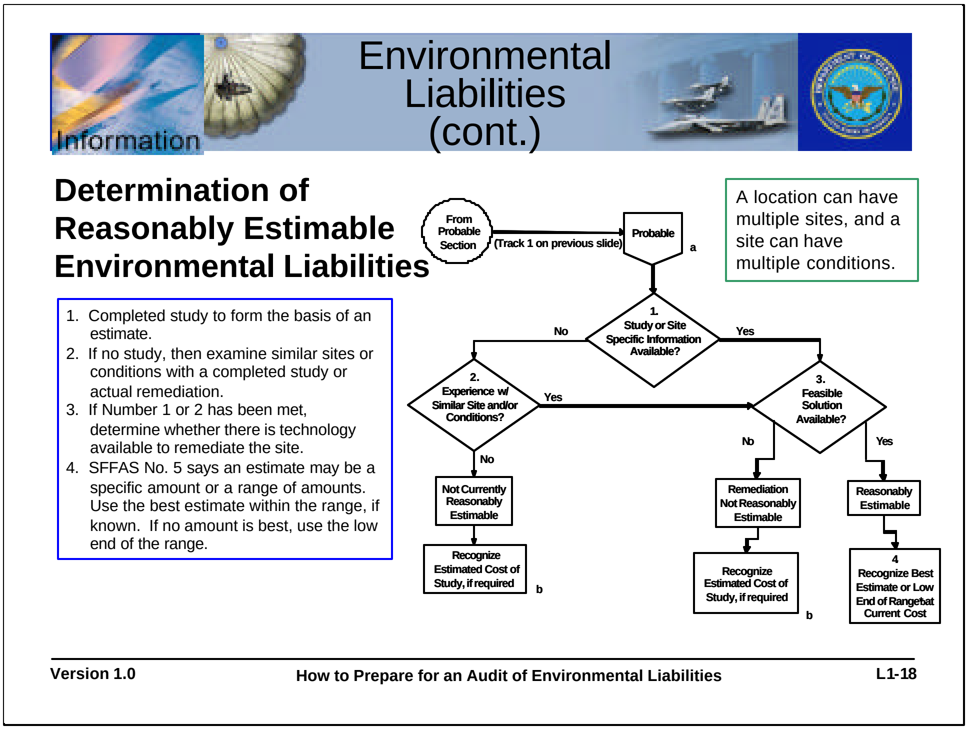
- Review of chain-of-custody records
- Review of aerial photos that may show prior uses
- Review of available records to show whether any previous release contaminant has occurred or is suspected
- Visual inspection of site to look for contamination
- Review complaints regarding abnormal health conditions.

Once due care is established, and there is a likely contamination, we move to the Step 2. Step 2 asks whether the event is government related and if the government is legally liable. If the answer is Yes, then we conclude that there is a determination of probable environmental liability. If the answer is No, we move to Track 2, Step 3, shown in the center column of the chart. Step 3 asks whether this is a government-acknowledged event. If the answer is No, then it is not probable. If the answer is Yes, move to Step 3.a. Step 3.a. asks if Congress has appropriated monies for this event and whether a transaction has already taken place. A transaction might include a contractor having done some cleanup and requesting payment. If the answer is No, then again it's not probable. If the answer is Yes, then move to the last step which states it is probable to the extent of costs incurred. This would include any required studies, costs associated with cleanup, or any other monies obligated or spent.

Questions to help determine probable:

- Are cleanup, closure, and/or post-closure monitoring costs likely; either now or upon disposal/closure?
- Are these costs related to the DoD's operation or use of the asset?

Let's discuss what is reasonably estimable.



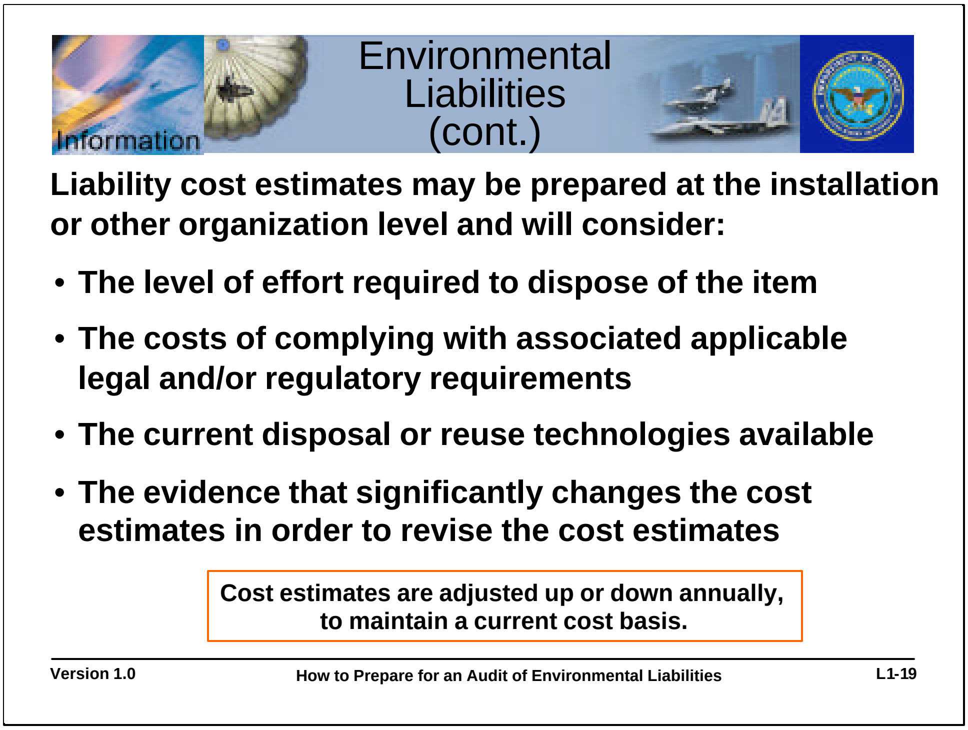
This slide continues from Track 1 from the previous slide. Track 2, Government Acknowledged, from the previous slide is not applicable. The government has accepted financial responsibility to the extent of authorized legislation or appropriation, and whether a transaction has already occurred. A prior transaction might cause another party to expect payment – as would be the case if a contractor has performed cleanup at a site.

Step 1 asks if a Remedial Investigation (RI)/Feasibility Study (FS) or other study has been completed. If the answer is No, Step 2 asks whether you have experience with similar sites or conditions. If the answer is No, then it is not reasonably estimable. If the answer is Yes, and we have completed a study you are asked if there is technology available to remediate the event. If the answer is No, then it is not reasonably estimable. If the answer is Yes, then it is reasonably estimable and proceed to Step 4. Step 4 tells you to recognize the best estimate or low end of a range at the current cost.

Questions you may answer to help determine whether a liability is reasonably estimable include:

- Has an interim corrective measure been issued? If so, is there sufficient information available to construct a reasonable estimate?
- If not, has a facility investigation been completed? This is the most common point at which an entity has sufficient information to prepare an estimate used to establish an environmental liability.
- If the results of the study indicate that no contamination exists, no further action is required.

Let's review some additional questions to help determine whether the liability is probable and estimable.



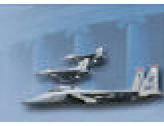
Environmental liability cost estimates may be prepared at the installation level and take into consideration:

- The level of effort required to dispose of the item
- The costs of complying with associated applicable legal and/or regulatory requirements
- The current disposal or reuse technologies available
- The evidence that significantly changes the cost estimates in order to revise the cost estimates.

It is important that cost estimates be adjusted to remain in current year dollars. Remember, these are reflected in the financial statements as current year dollars.

We've discussed liabilities in general, now let's look at the definition of an environmental liability.

Environmental Liabilities (cont.)



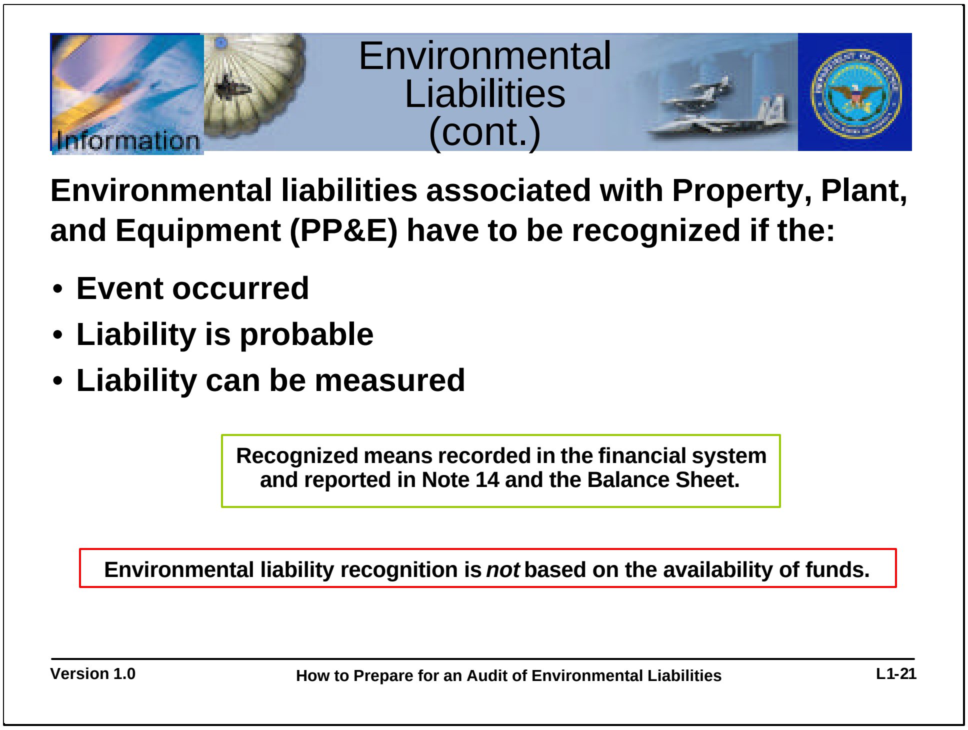
Environmental liability: a legal obligation to make future expenditures related to a past or on-going DoD activity that adversely affected the environment. It can include estimated amounts for future cleanup of contamination resulting from waste disposal methods, leaks, spills, and other past activities that have created a public health or environmental risk.

Environmental liabilities fall in two distinct categories:

- **Defense Environmental Restoration Program**
- **Non-Defense Environmental Restoration Program**

The past activities mentioned in this definition of an environmental liability, include activities that are being operated in accordance with existing environmental regulations, but will have closure or post-closure monitoring costs.

Now let’s look at how we know we can place a liability on the financial statements.

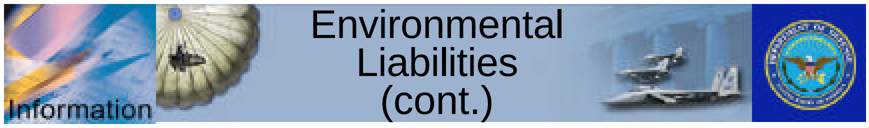


Environmental liabilities must be estimated and recognized when associated with disposal of property, plant, and equipment (PP&E), or when associated with corrective actions and the future closure of facilities on active installations.

Recognizing a liability means it is recorded in the financial system and reported on the Balance Sheet. Note 14 further details the elements recognized on the Balance Sheet.

Measurement, or estimates, are an important part of the liability process.

Let’s examine those items more closely.



PP&E Affected by Environmental Liabilities

- **Real Property**
  - **Lands and improvements, including previously owned**
  - **Buildings and structures**
  - **Installed equipment**
  - **Capital leases**
  - **Leasehold improvements**
  - **Asset owned in possession of others**
  - **Land in connection with PP&E construction**
  - **Land rights**
- **Military Equipment**
  - **Weapons systems**
  - **Support PP&E**
  - **Vessels in preservation status**

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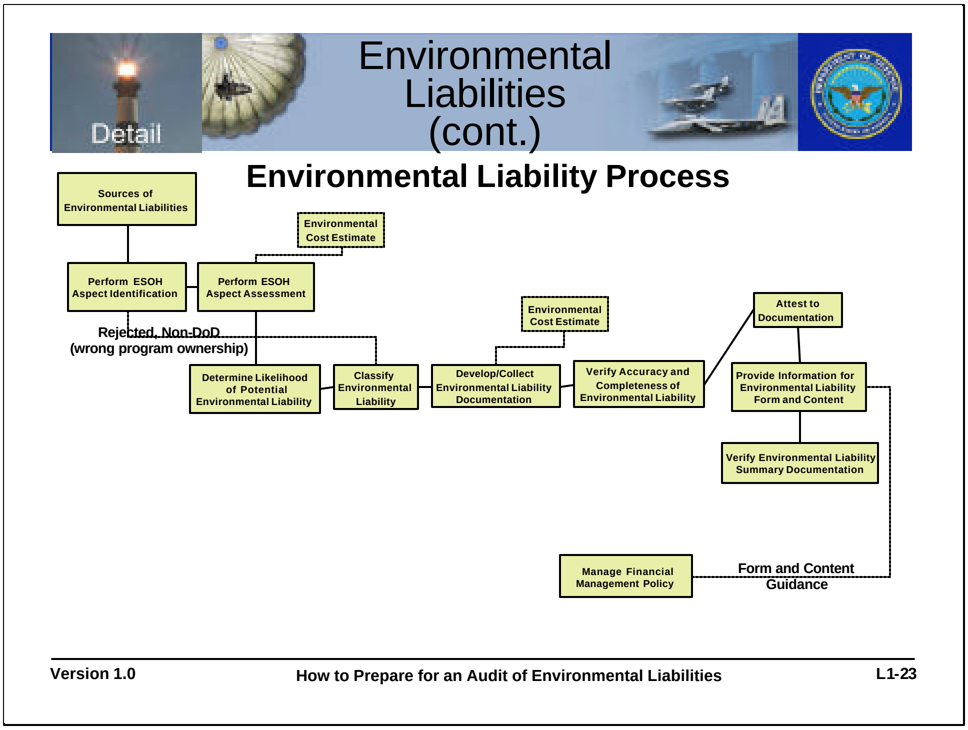
Much of our environmental liabilities stem from real property or related activities, so it's a good idea to understand what is real property. The Department's real property holdings are absolutely huge, consisting of more than 600,000 buildings, structures, and facilities, located at more than 4,700 locations, on approximately 30 million acres of land. Real property ranges in size from small unoccupied locations supporting a single navigational aid on less than one-half acre to installations consisting of over 3 million acres.

Real property consists of lands and improvements to land; buildings and structures, including improvements and additions. It also includes installed equipment built into a facility, as an integral part of the facility (such as heating systems), but does not include movable equipment (such as plant equipment). In many instances, this term is synonymous with real estate.

In addition to real property, the Department has other PP&E holdings that must be tracked to ensure associated environmental liabilities are properly recorded. Military equipment such as weapon systems and support PP&E make up a significant portion of the liabilities reported on Note 14.

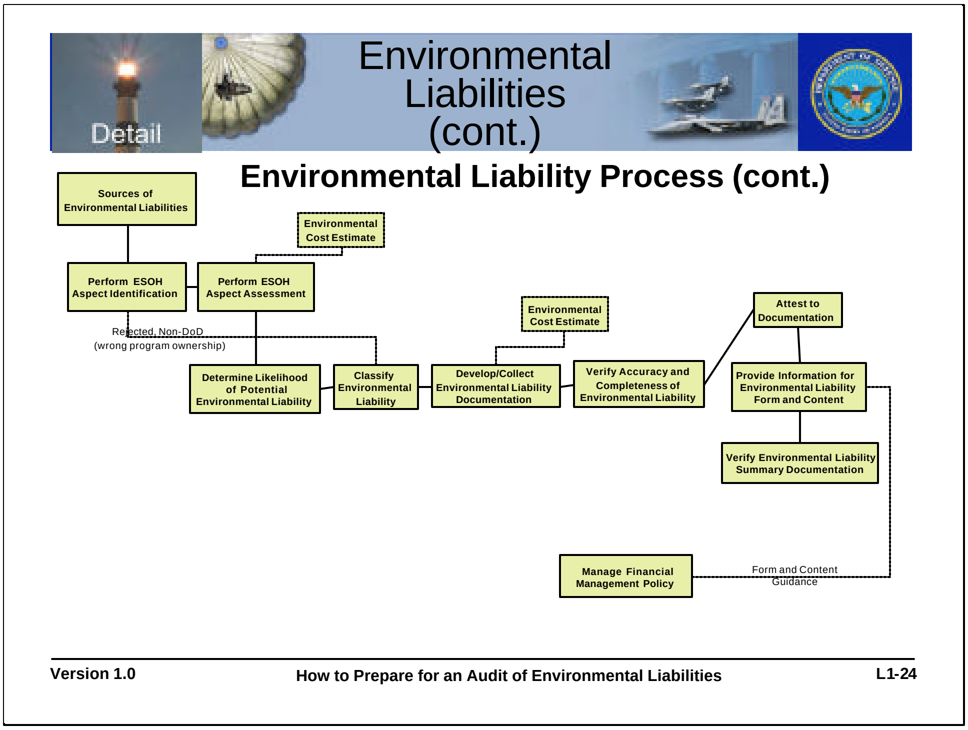
On the next few slides, we put the information reviewed so far in a series of steps to determine an environmental liability.



This slide is an overview of environmental liabilities as they progress through the various activities within the Department. There are general categories of activities, those that create the liabilities, the engineering activities, and the financial activities. At the top left, we begin with the source of environmental liabilities, whether from external non-DoD sources or from DoD users. Next, Environmental Safety and Occupational Health (ESOH) aspect identification, is the task that reflects the initial actions taken to identify the activities, locations, products, and services where environment, safety and health concerns exist. Next we perform the ESOH aspect assessment which is the study or investigation of environment, safety, and occupational health aspects or issues and the determination of the nature and extent of the issue. We then determine the likelihood of potential environmental liabilities. This requires that we collect the information needed to determine if the likely outflow of future resources is probable, possible, or remote and if the cost can be reasonably estimated as discussed earlier. Next we classify the environmental liability by balance sheet classification.

As we develop/collect environmental liability documentation, our objective is to capture information to support the valuation of the estimate, the method in which it was derived, and associated information related to the management of the liability. This task also includes preparation of a summary document that is a record of the pertinent information collected in each step and the physical location of each document associated with the pertinent information. One purpose of the summary document is to ensure existence of all supporting documentation and to enable tracking a transaction through the referencing or linking of documents.

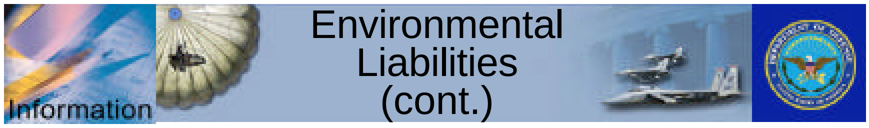
The supporting documentation collected for each major step in the process is verified for accuracy and completeness. This process of verification includes an examination of the methods used to develop the estimate and a determination of the reasonableness of all estimates associated with the specific liability.



After the bibliographic information is verified, a supervisor must attest that the documentation is complete and reasonable. This step involves the supervisor formally attesting to the summary document thereby ensuring that the documentation is complete in terms of the audit trail and that the estimate is reasonable in nature.

The next task collects and formats the environmental liability information for form and content using information such as budget execution data, expenses, or revenue. It is followed by the verification task. This task does not review the documentation itself but verifies that appropriate supervisory controls were exercised. This task is accomplished through the review of a summary document or other suitably defined data collection instrument that outlines the environmental liability milestones and collects a signature denoting supervisory review of the milestone. The general steps in this process are: review for existence – proof or attestations that the proper documentation exists and has been properly reviewed and attested to by the proper level of authority; review for completeness – ensure all necessary documentation is available in sufficient detail to allow an outside reviewer to trace estimates and decisions back to their origin; and seek additional documentation if information provided is not sufficient.

The last task on our slide includes the creation, maintenance and dissemination of policies, requirements and directives governing the processing of financial transactions, performance of financial management activities and maintenance and application of financial data, accounts and classification structures. This process includes the integration of external guidance (for example, impact analysis of new regulations, revision of existing guidance and generation of new processes). Now let’s look at additional guidance on creating liability estimates.



Liability estimates are created in accordance with the following:

- **Use current year costs**
- **Based on existing laws, technology, and management policies**
- **Assumptions must be well documented and saved as a baseline estimate**
- **Incremental direct costs should be considered on a site-by-site basis. Examples include facility studies, long term fees to engineering and consulting firms, required fees for permits and approvals and other such costs.**

Post-closure monitoring costs for on-going operations should be operating under the assumption of a clean-close assuming that ongoing activities are operating in compliance with laws, regulations, and policies, that exempts these sites from conducting post-closure groundwater monitoring.

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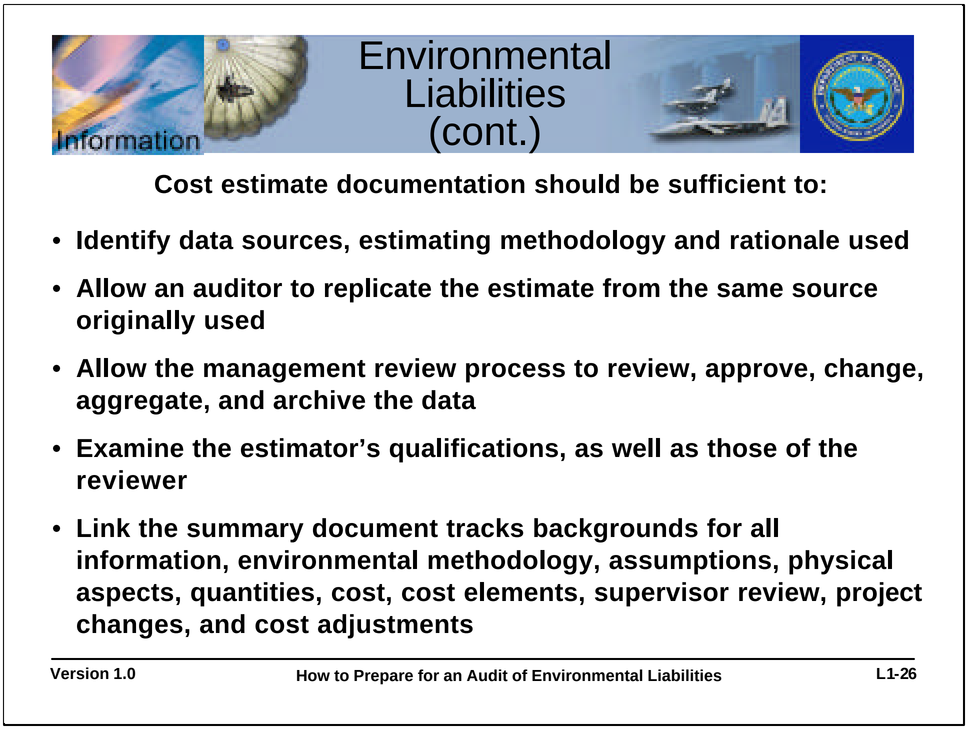
Once you have determined that an environmental liability exists and that the liability is probable according to the rules previously discussed, you need to create the estimate.

The estimate should be created in accordance with the following:

- Use current year costs
- Based on existing laws, technology, and management policies
- Assumptions must be well documented and saved as a baseline estimate
- Incremental direct costs should be considered on a site-by-site basis and include facility studies, fees to engineering and consulting firms, required fees for permits and approvals and other such costs.

It should be assumed that post-closure monitoring costs for on-going operations are operating toward a clean-close. This means that ongoing activities are operating in compliance with laws, regulations, and policies, that exempts these sites from conducting post-closure groundwater monitoring.

Next let's talk about some of the documentation that should be retained after the estimate is created.

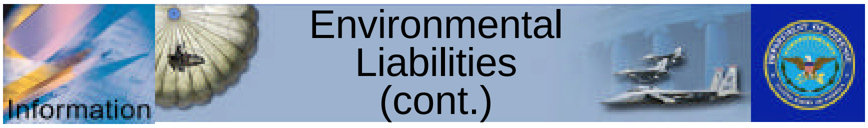


Adequate documentation and retention of that documentation is essential to achieving the audit results that the Department seeks. The initial estimate becomes the baseline estimate and as changes occur over time, the estimate is changed to reflect such factors as inflation, requirements, and technology. The new assumptions must be documented and retained.

After the estimate is created, documentation must be sufficient to:

- Identify data sources, estimating methodology, and the rationale used
- Allow an auditor to replicate the estimate from the same source originally used
- Allow the management review process to review, approve, change, aggregate, and archive the data
- Examine the estimator's qualifications as well as those of the reviewer
- Ensure the summary document tracks background information, environmental methodology, assumptions, physical aspects, quantities, cost, cost elements, supervisor review, project changes, and cost adjustments.

Next, let's examine some of the actions that should be taken by the entity that creates the estimate.



Environmental Liabilities (cont.)

The entity that created the environmental liability should be the one that takes the following actions:

- **Estimate – create the environmental liability estimate**
- **Track – follow the estimate to ensure its progress is properly coordinated and documented**
- **Revise – develop estimates to reflect all pertinent changes**
- **Monitor – retain ownership of the estimate**
- **Recognize – ensure the appropriate environmental liabilities are entered in accounting systems and reported in the financial statements**
- **Correct – update deficiencies to ensure the most accurate estimates are produced**

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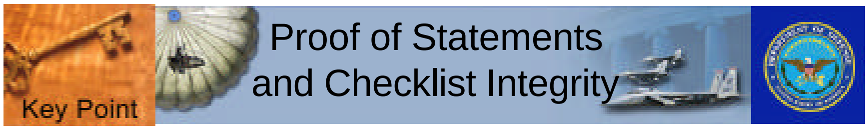
The entity that created the environmental liability should be the one that takes certain actions. Also, in the absence of host-tenant agreements, the owner of the site, or holder of the environmental permits will be the one responsible to take the following actions regarding the environmental liability:

- Estimate – create the environmental liability estimate
- Track – follow the estimate to ensure its progress is properly coordinated and documented for such actions as supervisory approval
- Revise – update the estimate to reflect all pertinent changes such as is required for annual inflation
- Monitor – retain ownership of the estimate as it is revised or otherwise corrected
- Recognize – ensure the appropriate environmental liabilities are entered in accounting systems and reported in the financial statements
- Correct – update deficiencies to ensure the most accurate estimates are produced.

Now let's look at the financial statements, with emphasis on the Balance Sheet.



Proof of Statements and Checklist Integrity

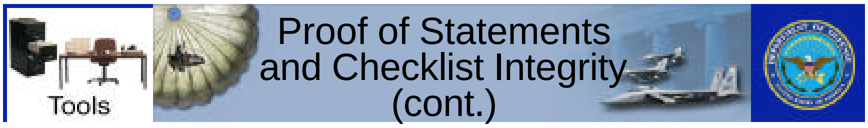
Financial Statements:

- **Balance Sheet**
- **Statement of Net Cost**
- **Statement of Changes in Net Position**
- **Statement of Budgetary Resources**
- **Statement of Financing**
- **Statement of Custodial Activity**
- **Notes to the financial statements**

The financial statements are a snapshot of the financial position of an entity as of a certain point in time. Various entities within the Department prepare financial statements that are consolidated quarterly. The DoD Consolidated Financial Statements as of the end of the fiscal year, September 30, are published in the annual Performance and Accountability Report (PAR). The financial statements are preceded by the section called Management Discussion and Analysis, in which management provides an overview of the scope of their operations, a report on their internal controls and conformance to financial systems requirements, and discusses any issues that may be important to users of the financial statements. They are followed by required supplementary stewardship information and other required supplementary information.

During an audit, amounts shown on the financial statements are verified through an examination of sample data and other evidence to ensure the reliability of the reported information. Environmental liabilities are found on the Balance Sheet and accompanying notes.

Let’s learn more about the Balance Sheet.



Proof of Statements and Checklist Integrity (cont.)

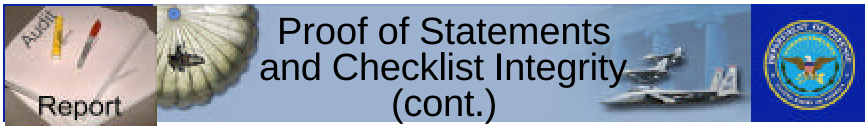
Balance Sheet is an expansion of accounting equation:
Assets = Liabilities + Net Position

The Department prepares the Balance Sheet in a report format with Assets shown at the top, followed by Liabilities in the middle, and finally the Net Position at the bottom.

We are concerned with liabilities, or claims against the Department, which are found on the Balance Sheet.

The Balance Sheet reflects the assets, liabilities, and the difference between assets and liabilities, called Net Position or referred to as equity.

Let’s look at the Department’s 2004 Consolidated Balance Sheet.



Balance Sheet

Department of Defense
Agency Wide
CONSOLIDATED BALANCE SHEET
As of September 30, 2004 and 2003
($ in Millions)

	2004 Consolidated	2003 Consolidated Restated
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)		
Entity	$ 287,685.5	$ 251,544.1
Non-Entity Seized Iraqi Cash	113.4	278.1
Non-Entity-Other	1,800.0	239.8
Investments (Note 4)	231,069.7	205,376.0
Accounts Receivable (Note 5)	1,118.3	1,066.6
Other Assets (Note 6)	1,011.9	105.0
Total Intragovernmental Assets	$ 522,798.8	$ 458,609.6
Cash and Other Monetary Assets (Note 7)	$ 2,178.1	$ 1,534.9
Accounts Receivable (Note 5)	7,427.8	7,299.9
Loans Receivable (Note 8)	70.7	64.0
Inventory and Related Property (Note 9)	213,219.4	205,544.6
General Property, Plant and Equipment (Note 10)	440,898.6	446,308.9
Investments (Note 4)	406.5	217.8
Other Assets (Note 6)	21,486.3	21,729.6
TOTAL ASSETS	$ 1,208,486.2	$ 1,141,309.3

LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	$ 1,888.4	$ 101.4
Debt (Note 13)	591.8	698.2
Environmental Liabilities (Note 14)	0.0	0.0
Other Liabilities (Note 15 & Note 16)	10,726.9	9,739.1
Total Intragovernmental Liabilities	$ 13,207.1	$ 10,538.7
Accounts Payable (Note 12)	$ 28,309.0	$ 27,863.8
Military Retirement Benefits and Other Employment-Related	1,569,704.7	1,429,565.5
Actuarial Liabilities (Note 17)		
Environmental Liabilities (Note 14)	64,367.2	61,490.6
Loan Guarantee Liability (Note 8)	34.4	25.9
Other Liabilities (Note 15 and Note 16)	34,491.2	30,154.0
Debt Held by Public	0.0	0.0
TOTAL LIABILITIES	$ 1,710,113.6	$ 1,559,638.5
NET POSITION		
Unexpended Appropriations (Note 18)	$ 243,813.9	$ 218,869.5
Cumulative Results of Operations	(745,441.3)	(637,198.7)
TOTAL NET POSITION	$ (501,627.4)	$ (418,329.2)
TOTAL LIABILITIES AND NET POSITION	$ 1,208,486.2	$ 1,141,309.3

Source: PAR: http://www.dod.mil/comptroller/financialindex.html

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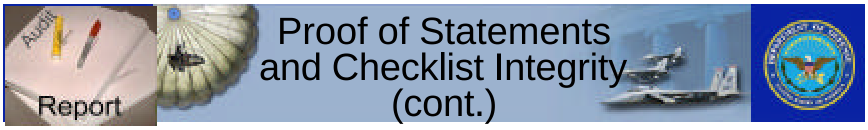
On the left side of the slide, the top portion of the Department's Consolidated Balance Sheet reflecting the Asset Section, is shown. On the right, the lower portions reflecting Liabilities and Net Position (or equity) are shown. Keep the equation in mind, Assets = Liabilities + Equity, as you examine the 2004 Consolidated column, on the left side of the slide under the green arrow. The equation is an important part of the proof of statements and must balance in order to support the statement as accurately reflecting the cumulative results of all transactions for the entity from its beginning. You should also know that the Balance Sheet is as of a specific point in time, as shown here for the end of FY 2004.

How do you know what information should be included in the financial statements and what might be left out? The answer is found in the SFFAS No. 1, Accounting for Selected Assets and Liabilities, that says materiality depends on the degree to which omitting or misstating information about an item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement. Notice in the Liabilities section, the items under Intragovernmental, including environmental liabilities. Also look further down the column to find the remainder of environmental liabilities. Notice the reference to Notes 14 and 15. Additionally, OMB Bulletin 01-09 established the Form and Content of Agency Financial Statements. Let's examine the Notes 14 and 15.



Proof of Statements and Checklist Integrity (cont.)

Note 14. Environmental Liabilities and Disposal Liabilities

As of September 30	2004			2003
	Current Liability	Noncurrent Liability	Total	Total
(Amounts in millions)				
1. Environmental Liabilities – Non Federal				
A. Accrued Environmental Restoration (DERP funded) Costs:				
1. Active Installations--Environmental Restoration (ER)	$1,752.0	$9,116.2	$10,868.2	$11,833.8
2. Active Installations--ER for Closed Ranges	63.3	7,645.7	7,709.0	4,362.1
3. Formerly Used Defense Sites (FUDS) -- ER	341.0	3,980.3	4,321.3	4,239.4
4. FUDS--ER for Transferred Ranges	149.3	13,935.0	14,084.3	13,624.4
B. Other Accrued Environmental Costs (Non-DERP funds)				
1. Active Installations--Environmental Corrective Action	52.3	517.3	569.6	561.0
2. Active Installations--Environmental Closure Requirements	16.0	162.5	178.5	103.6
3. Active Installations--Environ. Response at Active Ranges	62.5	217.1	279.6	276.3
4. Other	0.4	8.8	9.2	50.0
C. Base Realignment and Closure (BRAC)				
1. BRAC Installations--Environmental Restoration (ER)	670.6	2,450.3	3,120.9	3,616.6
2. BRAC Installations--ER for Transferring Ranges	11.3	524.6	535.9	511.6
3. BRAC Installations--Environmental Corrective Action	15.3	152.5	167.8	187.9
4. Other	209.3	0.0	209.3	190.4

Non-current Liability

- **Cost estimates (beyond current year through completion)**

Current Liability is a portion of:

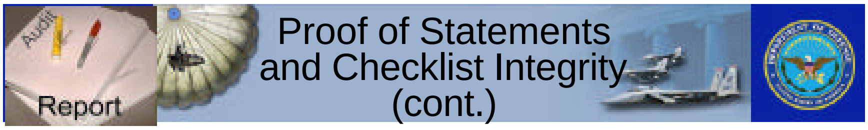
- **Defense Finance and Accounting Service (DFAS) provided unliquidated obligations (ULOs)**
- **Site-level upcoming current year allocation**

The Balance Sheet Notes sections explain the financial statement items in greater detail. Financial statements fluctuations greater than 10 percent are generally explained within the Notes; however, any change that is determined material is also explained.

Here in Note 14, we see the DERP liabilities at 1.A. and non-DERP liabilities at 1.B. We also find Base Realignment and Closure (BRAC) liabilities at 1.C. Typically, DERP are about 60 percent of the environmental liabilities. Notice the column headings under 2004 for Current Liabilities and Noncurrent Liabilities near the green arrows. In our earlier discussion on definitions, we said the current column should reflect those that will be paid within the next 12 months, while the noncurrent column shows those that will not be paid within the next 12 months. The estimated total clean up cost for the current operating period is assigned based on the amount of the current year appropriation and unliquidated obligations (ULOs) that will be expended within 12 months from the Balance Sheet date. The noncurrent clean up cost is the portion of the clean up cost that will be expended more than 12 months from the Balance Sheet date.

Later we will discuss cost estimates, but now is a good time to show where they affect the financial statements. Cost estimates are used to form the Noncurrent Liabilities shown in Note 14.

The last section of Note 14 follows on the next slide.



Note 14 (cont.)

D. Environmental Disposal for Weapons Systems Programs				
1. Nuclear Powered Aircraft Carriers	0.0	5,693.0	5,693.0	5,565.0
2. Nuclear Powered Submarines	42.4	5,146.3	5,188.7	4,888.9
3. Other Nuclear Powered Ships	86.5	201.0	287.5	269.1
4. Other National Defense Weapons Systems	5.8	266.1	271.9	297.1
5. Chemical Weapons Disposal Program	1,096.9	9,672.6	10,769.5	10,810.3
6. Other	103.0	0.0	103.0	103.1
2. Total Environmental Liabilities:	$ 4,677.9	$ 59,689.3	$ 64,367.2	$ 61,490.6

Continuing with Note 14, we see Section 1.D., Environmental Disposal for Weapons Systems Programs, broken into current and noncurrent liability columns on the right, to assist reader comprehension. In the third column, in red, you find the 2004 Total Environmental Liabilities amount of $64,367.2. This is the same figure reported on the previous Balance Sheet we discussed for environmental liabilities. This balancing of the two numbers is one of the checks that must occur.

Next we move on to examine the checklists found in the Government Accountability Office (GAO)/President's Council on Integrity and Efficiency (PCIE) Financial Audit Manual (FAM), or "the FAM" for short.

Proof of Statements and Checklist Integrity (cont.)

Government Accountability Office/President's Council on Integrity and Efficiency Financial Audit Manual (GAO/PCIE FAM)

The GAO/PCIE FAM comes in two volumes containing the methodology and tools that an auditor uses when conducting an audit. These are also tools you can use to prepare for an audit. One of the more important sections you should become familiar with is the Checklist for Federal Accounting, Reporting, and Disclosures (FAM 1050).

This checklist has 11 sections, including one for each of the financial statements. Since the financial statements are interrelated, some questions concerning line items in one financial statement may also pertain to line items in another statement. Because of these relationships, the general organizational approach aggregates related information so that questions on related line items appearing in more than one financial statement are covered only in the first financial statement section in which the line item appears.

Next we will look at two sample questions from this checklist related to the Balance Sheet.

Proof of Statements and Checklist Integrity (cont.)

Balance Sheet Sample Checklist Questions

345. If material, does the entity separately recognize a contingent liability for environmental clean-up costs[83] for PP&E if the following criteria apply?

  a. they are related to a past transaction or event

  b. the related costs are probable and measurable (SFFAS 5, par. 38 & SFFAS 6, par. 91-93; OMB Bulletin 01-09, pp. 25 & 26, section 3.4)

351. Does the entity also disclose the following information related to clean-up costs?

  a. the sources (i.e., applicable laws and regulations) of clean-up requirements

  b. the method for assigning estimated total clean-up costs to current operating periods (e.g., physical capacity versus passage of time)

  c. the unrecognized portion of estimated total clean-up costs associated with PP&E

  d. the material changes in total estimated clean-up costs due to changes in laws, technology, or plans

  e. the portion of change in an estimate that relates to prior-period operations

  f. the nature of estimates and the disclosure of information regarding possible changes due to inflation, deflation, technology, or applicable laws and regulations (SFFAS 6, par. 107-111; OMB Bulletin 01-09, p. 81, section 9.15)

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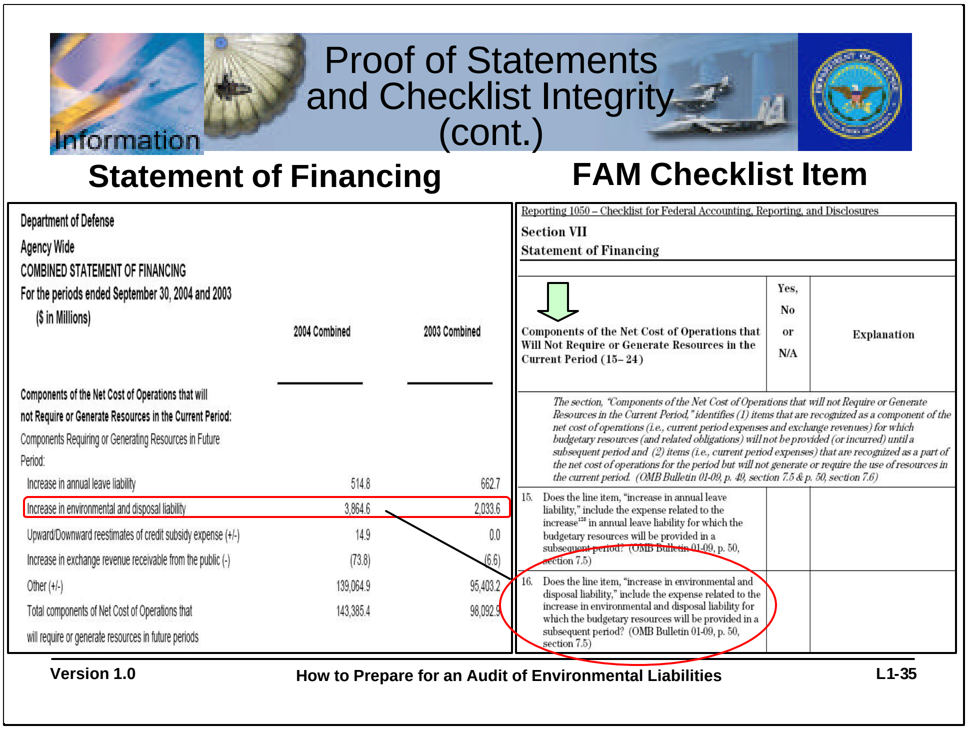
The Balance Sheet questions are found in Section III of the checklist. These can also be seen in Appendix E of our text.

A review of these questions provides significant insight into what the auditors will be doing during their visit, so let's go to Appendix E and review a few of the questions.

The questions related to environmental liabilities on the Balance Sheet are questions 345 through 351. Here, question 345 reiterates the rules for recording and reporting a liability, probable and measurable. Question 351 looks at issues related to documentation.

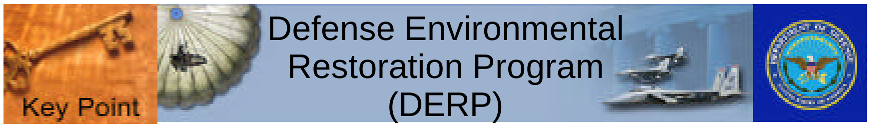
Determine if there is an audit trail to substantiate the various requirements related to clean-up costs.



The Statement of Financing bridges an entity's budgetary and financial or proprietary accounting. Most entity transactions are recorded in both budgetary and proprietary accounts; however, some transactions may only appear in one set of accounts, like the accrual of environmental and disposal liabilities that is recorded only in the proprietary records.

The Statement of Financing first identifies total resources used by an entity during the period (budgetary and other) and then makes adjustments to the resources based upon how they were used to finance net obligations or net cost. The section called Components of the Net Cost of Operations Will Not Require or Generate Resources in the Current Period, shown here near the green arrow, adjusts total resources used to finance the activities of the entity to account for items that were part of the net cost of operations, but were not included in net obligations. Items included here are those in which the expense was recognized in the current period, but the budgetary resource and obligation will be recognized in a future period. An example is unfunded environmental liabilities accrued in the current period, that will be funded, obligated, and liquidated in a future period.

We've talked about how environmental liabilities affect the financial statements and some of the tools used to ensure their accuracy; now let's examine those liabilities related to the DERP.



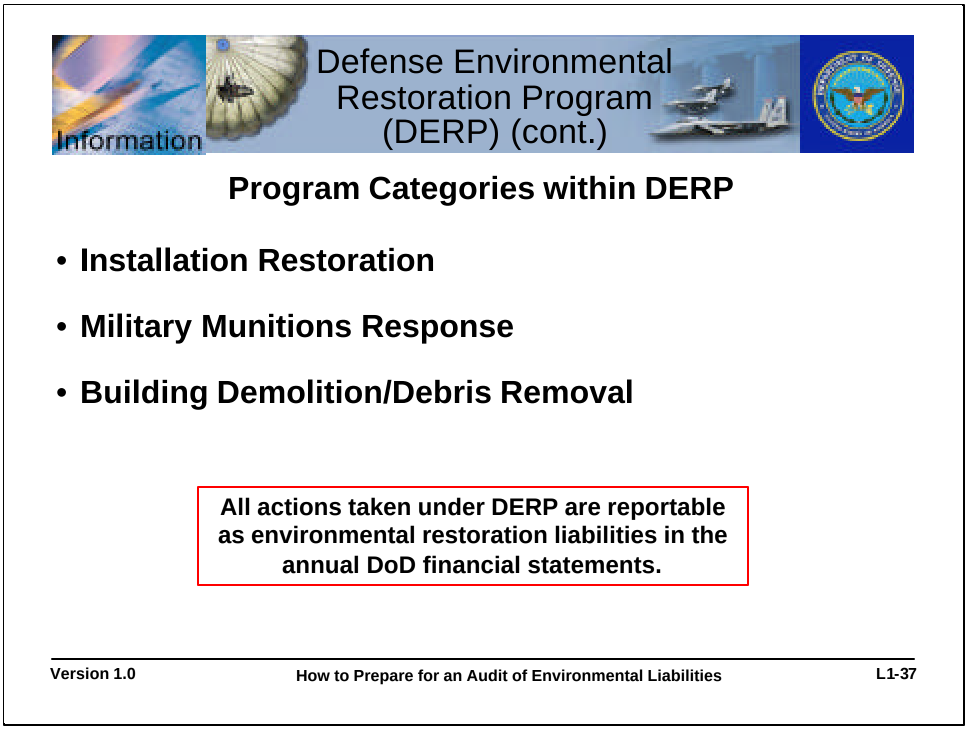
Chronology of DERP Development

- **1975 – Installation Restoration Program (IRP) begins**
- **1980 – Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) passed**
- **1986 – Superfund Amendments and Reauthorization Act (SARA) refined and expanded CERCLA, and formally established DERP**
- **1988 – BRAC authorized**
- **1991 – BRAC authorized**
- **1993 – BRAC authorized**
- **1995 – BRAC authorized**
- **2005 – BRAC authorized**

In 1975, the Department began environmental restoration activities under its Installation Restoration Program (IRP). Prior to this, the DoD was not legally required to address property impacted by past operations. This changed in 1980 when Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), also known as the Superfund. This law required all responsible parties to clean up releases of hazardous substances to the environment. The 1986 Superfund Amendments and Reauthorization Act (SARA) refined and expanded CERCLA, and formally established the Defense Environmental Restoration Program, known as DERP. The DERP is codified in Section 2701 of Title 10 of the U.S. Code (USC).

It was also during the 1980s that Congress realized the Department no longer needed some of its installations, and that realigning missions and workload at other installations could improve efficiency. Congress has authorized five rounds of BRAC – 1988, 1991, 1993, 1995, and 2005. The Department is cleaning up installations intended for transfer to non-DoD parties for other uses and realigning installations that remain DoD property.

Next we view program categories within the Defense Environmental Restoration Program.

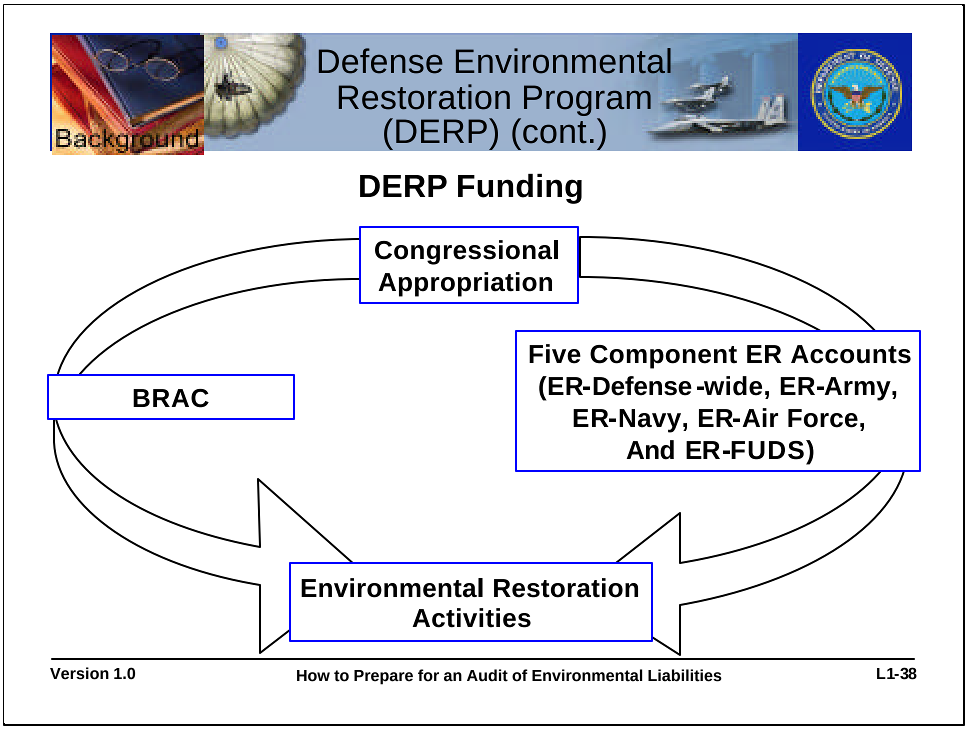


There are three program categories within DERP:

- Installation Restoration – this category includes the identification, investigation, research and development, and cleanup of contamination from hazardous substances, pollutants, and contaminants
- Military Munitions Response – this category includes the correction of other environmental damage (such as detection and disposal of unexploded ordnance) that creates an imminent and substantial endangerment to the public health or welfare or to the environment
- Building Demolition/Debris Removal – this category includes the demolition and removal of unsafe buildings and structures, including DoD buildings and structures at sites formerly used by and under the jurisdiction of the Office of the Secretary of Defense (OSD).

Earlier, we looked at how to identify environmental liabilities. However, there continues to be questions on how to differentiate between a DERP liability and a non-DERP liability.

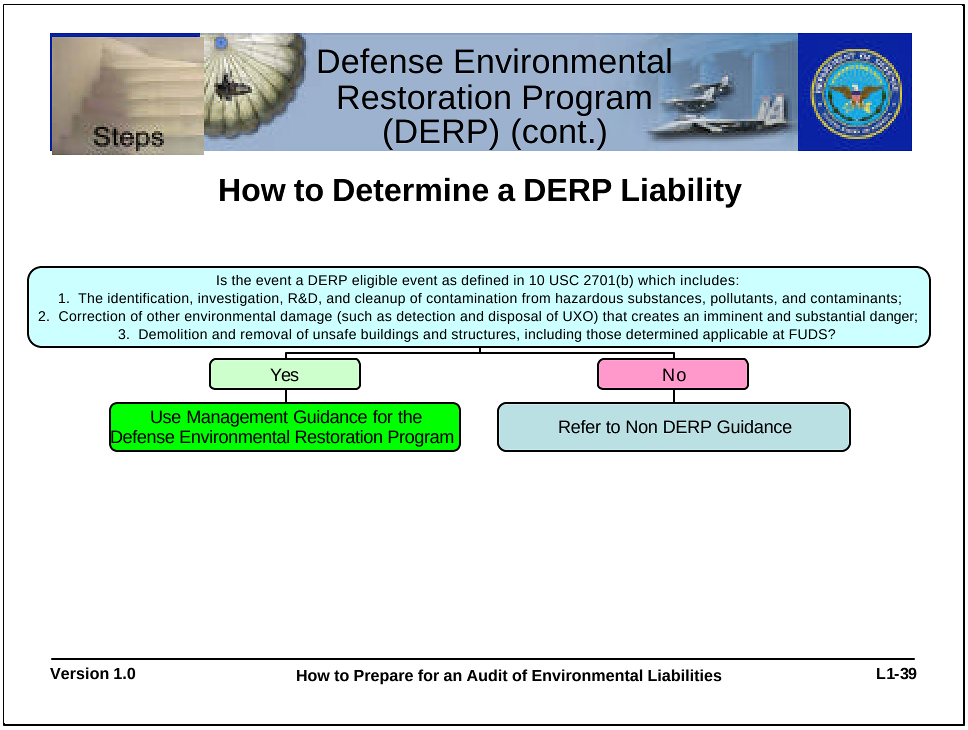
On the next few slides we will examine the steps to help you determine the types of liabilities.



Prior to the 1998 DoD Appropriations Act, Congress funded the Defense Environmental Restoration Account (DERA), which in-turn funded the operations and maintenance or Military Construction (MILCON) accounts where the environmental contamination was located. After the 1998 DoD Appropriations Act, Congress began funding five component accounts directly. These are the Environmental Restoration (ER) – Defense-wide, ER-Army, ER-Navy, ER-Air Force, and ER-Formerly Used Defense Sites (FUDS).

Environmental restoration may be conducted at operating installations or a FUDS. The accrued environmental restoration costs may be related to General PP&E, including land, and stewardship land. Examine Note 14 and notice that DERP reporting is shown in line 1.A and BRAC is reported on line 1.C. 1 and 2.

The steps to determine whether a liability is DERP or non-DERP can be confusing; however, the next few slides will help you understand the differences.



To determine a DERP or non-DERP liability, ask if the event is a DERP-eligible event, as defined by law. This includes the following, as shown on the slide:

1. The identification, investigation, research and development, and cleanup of contamination from hazardous substances, pollutants, and contaminants
2. Correction of other environmental damage (such as detection and disposal of unexploded ordnance) that creates an imminent and substantial danger;
3. Demolition and removal of unsafe buildings and structures, including those determined applicable at FUDS.

If the answer is Yes, refer to the DERP guidance for proper handling. If the answer is No, refer to the non DERP guidance discussed in a few minutes.

We just mentioned the DERP Guidance, so let's take a look at it now.

Defense Environmental Restoration Program (DERP) (cont.)

The "Management Guidance for the Defense Environmental Restoration Program (DERP) of September 2001," applies to all environmental restoration response activities and actions that:

- **Are undertaken by a Component**
- **Are conducted at a currently owned facility, a FUDS, or areas contaminated by them**
- **Address a release of CERCLA hazardous substances, pollutants, or contaminants, or the demolition and removal of unsafe buildings**

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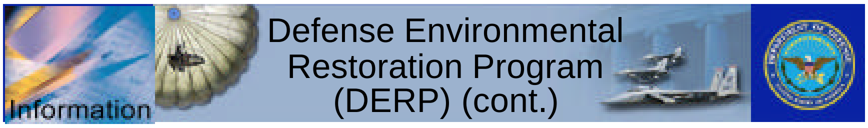
The Management Guidance for the Defense Environmental Restoration Program (DERP) applies to all environmental restoration response activities and actions that:

- are undertaken by a Component
- are conducted at a currently owned, leased, or possessed facility, a FUDS, or areas where materials have come to rest that were released by a current site or a FUDS
- address a release of CERCLA hazardous substances, pollutants, or contaminants, or a release of Petroleum, Oil, and Lubricant (POL);
- a release of hazardous wastes
- a release of low-level radioactive materials or wastes
- Unexploded Ordnance (UXO) or Waste Military Munitions (WMM) or their chemical residue
- the correction of other environmental damage which creates an imminent and substantial endangerment to health or environment; or the demolition and removal of unsafe buildings and structures.

Let's discuss the two major components of DERP, BRAC, and FUDS.



Defense Environmental Restoration Program (DERP) (cont.)

Through BRAC, the Department is preparing properties for transfer to other entities. Because the Department will not own these properties in the future, it must carefully consider its DERP activities and how the properties will be used in the future.

As mentioned earlier, to sustain Military readiness and improve the Defense mission during changing times and requirements, the Department recognized the need to close some of its installations and realign DoD missions at others. In the late 1980s and early 1990s, the DoD worked with Congress to identify installations that could be closed or realigned. The result was four rounds of BRAC - in 1988, 1991, 1993, and 1995. The latest round was recently initiated in 2005.

While the Department is realigning missions or transferring property at some BRAC installations, a large portion of BRAC property is intended to be transferred to other federal and non-federal agencies. Of the estimated 400 BRAC installations, 206 have required some type of activity under the DERP, before the property can be ready for transfer.

In addition to environmental restoration, the Department also considers the possible economic and social effects of installation closures. When an installation is closed or realigned, the Department understands that the local community will want to return the available property to productive use as quickly as possible. To facilitate transfer and economic reuse, the Department strives to conduct environmental restoration activities as efficiently and effectively as possible. Economic redevelopment and reuse are the responsibility of the Office of Economic Adjustment (OEA).

Let's look at FUDS.

Defense Environmental Restoration Program (DERP) (cont.)

The Department does not own or control access to FUDS properties that have often been put to new uses.
All response actions are conducted under DERP.

Response actions include site identification, investigation, removal actions, remedial actions, or a combination of removal and remedial actions.

Properties determined ineligible for the FUDS program are referred to an appropriate Component, other federal agency, or federal or state regulatory agency for action.

The U.S. Army Corps of Engineers (USACE) is the Department's executive agent for the FUDS program.

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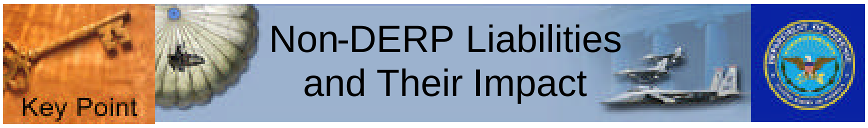
FUDS are real properties the Department has owned, leased, or operated and may be located throughout the U.S. and its territories. When thinking about FUDS, it is important to remember that these are now owned by private individuals, corporations, state and local governments, other federal agencies, or tribal governments. Response actions such as site identification, investigation, removal actions, remedial actions, or a combination of removal and remedial actions, are conducted through DERP at FUDS.

The Department's executive agent for FUDS is the Army, where the U.S. Army Corps of Engineers (USACE) manages and executes the program. Information about the origin and extent of contamination, land transfer issues, past and present property ownership, and program policies must be evaluated, before a property is eligible for DERP funding under the FUDS program.

Let's discuss non-DERP liabilities.



A non-DERP environmental disposal and closure liability is one that is not a DERP qualified activity. The major categories of non-DERP environmental liabilities are:

- **Active installations:**
  - **Environmental corrective action**
  - **Environmental closure requirements**
  - **Environmental responses at active ranges**
- **BRAC**
  - **Environmental corrective actions**
  - **Other**
- **Environmental disposal for weapons systems programs**

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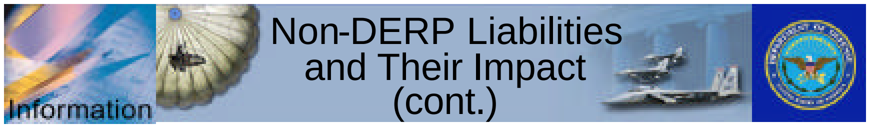
Non-DERP is explained as one that is not a DERP qualified activity. They are found in Note 14 at lines 1.B., 1.C. 3 and 4, and 1.D. The non-DERP environmental liabilities constitute approximately 40 percent of the recognized liabilities and therefore have a substantial impact on the financial statements.

Look at Note 14 now, as we review the non-DERP lines.

Over the next few slides, we highlight some of these categories.



Environmental Corrective Action

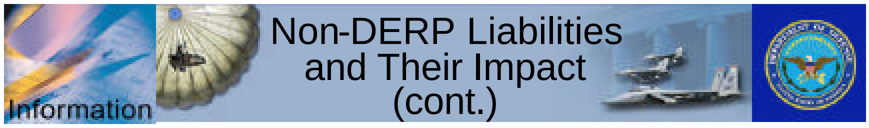
- **Site contaminated as a result of actions under a permit**
- **Funded, using the funding source for the permitted activity**

An example corrective action would occur when cleaning up a site contaminated as a result of a release at a permitted site.

Environmental corrective action is aimed at sites contaminated as a result of permitted actions. Permits may stem from the Resource Conservation and Recovery Act (RCRA), as well as other permitting processes. These sites are funded using the funding source supporting the permitted activity that helps define them as non-DERP activities.

An example of corrective action would include cleaning up a site that was contaminated as a result of a release at a permitted site. In this example, we assume the cleanup is after the initial response and we also assume this will be a multi-year response effort. Such a release might result when an installation's sewage treatment plant is flooded by excessive rain causing a release of contaminated waste water into a nearby stream.

Let's look at environmental disposals and closures next.



Environmental Disposals and Closures

- **Sites have environmental requirements related to their future decontamination and decommissioning.**
- **Sites operate in a compliant manner and create no environmental liabilities during their useful lives.**
- **Sites may incur some closure, monitoring, or disposal costs, when they are no longer in operation.**

Examples would include costs for the eventual closing and post-closing monitoring of solid waste landfills; hazardous waste treatment, storage, and disposal facilities; and open-burn or open-detonation sites.

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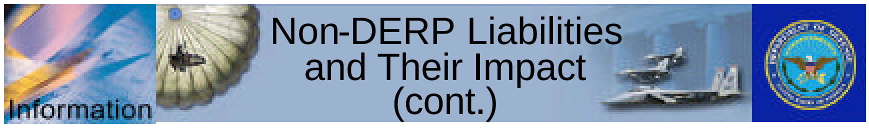
Environmental closure liabilities are associated with the future closure of facilities that have environmental requirements related to their future decontamination and decommissioning. Some examples include facilities that may have costs tied to eventual closing as well as post-closure monitoring of solid waste landfills; hazardous waste treatment, storage, and disposal facilities; and open-burn or open-detonation sites.

The belief is that these ongoing activities will operate in compliance with all applicable laws and regulations and thereby not create an environmental liability. However, there may be some closure, monitoring, or disposal costs when the operation ceases.

Next we examine responses at operational ranges.



Non-DERP Liabilities and Their Impact (cont.)

Environmental responses at operational ranges are taken to contain an environmental contaminant that creates a substantial endangerment to health or environment.

Ranges operated per regulatory requirements are not expected to create environmental liabilities; however, should a release from the range occur, an environmental liability is created.

Environmental responses for Military munitions are taken to contain an environmental contamination, whether on the surface or below, that creates an imminent and substantial public or environmental health hazard. Contamination includes munitions constituents (MCs) at operational ranges on active installations.

It is intended for ranges to operate in accordance with all laws and regulations and therefore not likely result in environmental liability. However, in the event of a release of MCs from a range occur, an environmental liability is created.

MC investigations are typically performed to confirm the presence or absence of MC contamination. If no information is available about MC contamination, sampling is conducted to determine whether it exists. This type of investigation is typically biased to look at areas where contamination is suspected to be the worst case. Limited sampling to evaluate the presence or absence of MC contamination should be conducted during the Site Inspection (SI) phase of a munitions response project. If MC contamination is confirmed, further investigation may be required to determine the nature and extent of the contamination, as well as to define the risk to human health and the environment.

This type of investigation would typically be conducted during the RI/FS phase of a munitions response project and should support preparation of a baseline risk assessment.

Next we talk about BRAC as it is related to non-DERP liabilities.

Information

Non-DERP Liabilities and Their Impact (cont.)

BRAC also includes non-DERP activities such as active installations with liabilities from permitted activities.

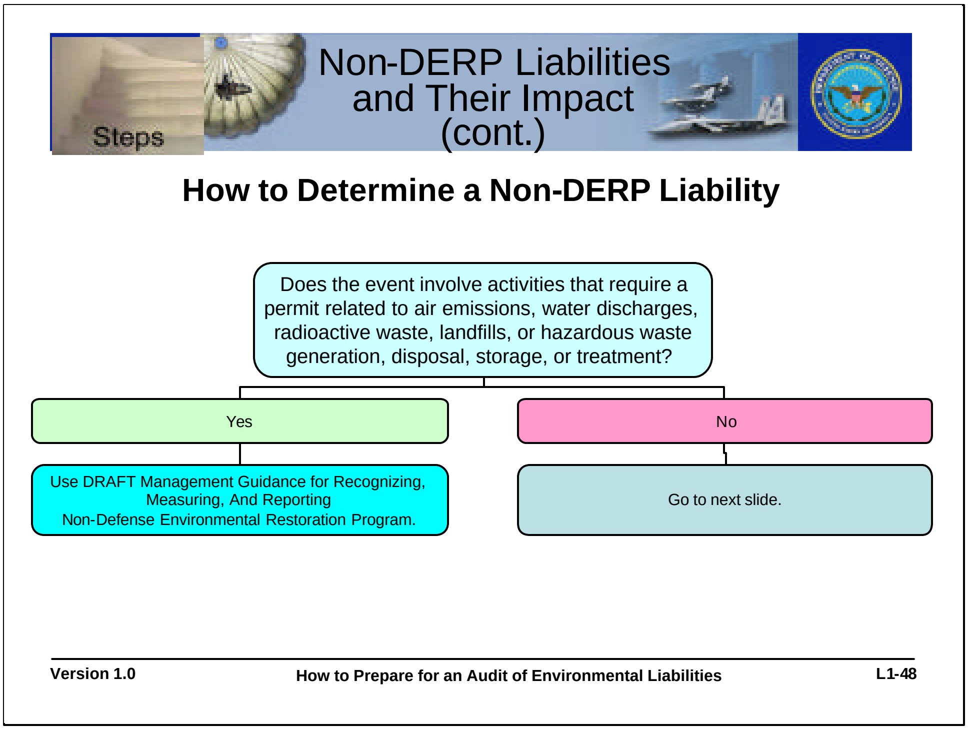
For sites transferred to BRAC, all non-DERP environmental liability estimates are transferred as well, to ensure no double counting on the Department's financial statements occurs.

Non-permitted activities are typically those that occurred prior to the Resource Conservation and Recovery Act (RCRA) of 1976 or similar permitting programs.

BRAC corrective actions are centered on disposal and cleanup at Military Installations undergoing closure or realignment of mission procedures. The goal of the BRAC program is to conduct environmental remediation as efficiently and effectively as possible to facilitate the transfer and reuse of the property.

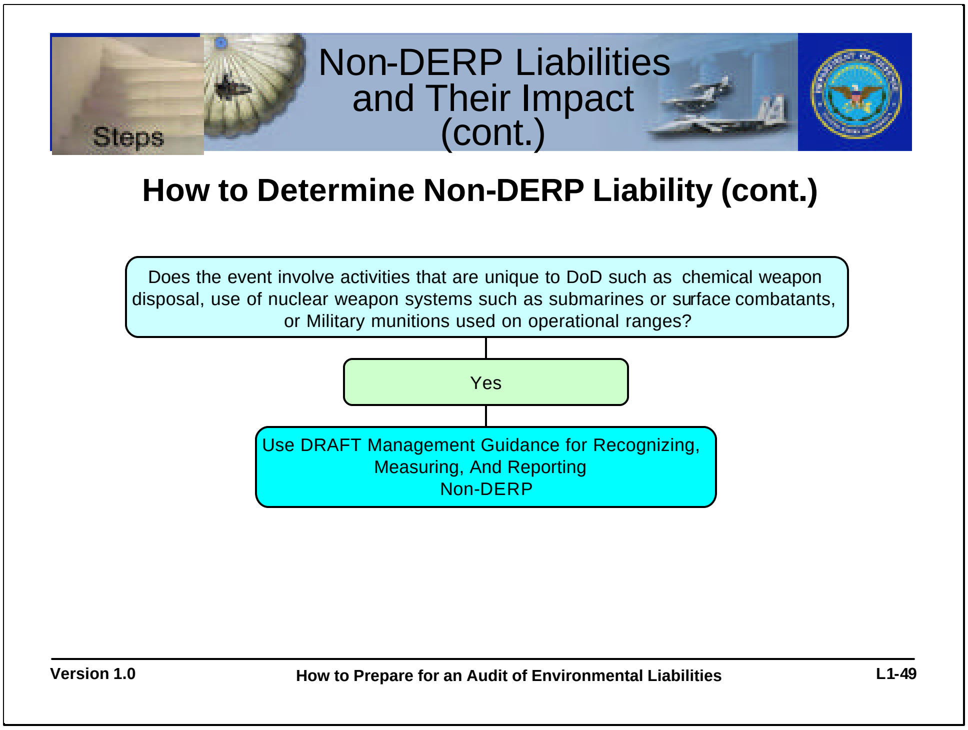
BRAC non-DERP support can be found at active installations with ground contamination as a result of permitted activities. Once the sites have been transferred to the BRAC program, the liability estimates are also transferred to allow continued tracking and reporting.

Let's examine some activities you can review to help determine potential liabilities.



Next, determine whether the event involves activities that require a permit related to air emissions, water discharges, radioactive waste, landfills, or hazardous waste generation, disposal, storage, or treatment. If the answer is Yes, refer to the DRAFT non-DERP guidance. We will discuss the draft guidance on non-DERP later.

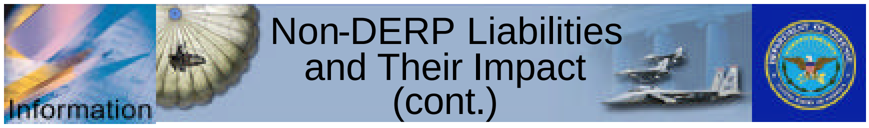
If the answer to the question is No, proceed to the next step as follows.



Next, determine whether the event involves activities that are unique to the Department, such as chemical weapon disposal, use of nuclear weapon systems such as submarines or surface combatants, or Military munitions used on operational ranges.

If the answer is Yes, refer to the non-DERP guidance for more information.

Let's discuss some additional factors to help determine a non-DERP liability.



Non-DERP Liabilities and Their Impact (cont.)

To determine potential non-DERP activities, review the operating licenses and environmental permits for:

- **Air emissions from boilers, furnaces, or other equipment**
- **Water discharges to Publicly Owned Treatment Works (POTW)**
- **Water discharges to National Pollution Discharge Elimination Systems (NPDES)**
- **Radioactive material sources and operations**
- **Underground Storage Tank (UST) and Aboveground Storage Tank (AST) operations**
- **Landfills**
- **Chemical weapons disposal**
- **Nuclear assets, such as the Navy's nuclear powered submarines and surface ships**

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To help determine if an non-DERP environmental liability event has occurred, review your environmental activities for inclusion on the Department's financial statements and Note 14. Some of the activities to review include the operating licenses and environmental permits for:

- Air emissions from boilers, furnaces, or other equipment
- Water discharges to Publicly Owned Treatment Works (POTW)
- Water discharges to National Pollution Discharge Elimination Systems (NPDES)
- Radioactive material sources and operations
- Underground Storage Tank (UST) and Aboveground Storage Tank (AST) operations
- Landfills
- Chemical weapons disposal
- Nuclear assets, such as the Navy's nuclear powered submarines and surface ships.

What is the impact of a non-DERP liability to your ongoing activities? Let's review factors that differentiate an environmental liability.

Information

Non-DERP Liabilities and Their Impact (cont.)

Recognize most non-DERP liabilities:

- **On an annual basis**
  - **Capability**
  - **Usage**
- **In total for RCRA sites**

Source: DoD OIG Draft Management Guidance For Recognizing, Measuring, and Reporting, Non-DERP Environmental Disposal and Closure Liabilities

Normally, most non-DERP liabilities are recognized in a systematic way to account for use of their physical capacity or just simply based on their useful life. This latter method is similar to depreciation expense in that the total liability is divided by the useful life and incrementally recognized in the financial statements.

An example of using capability as a basis for recognition might be a landfill. If the landfill is capable of holding a specific amount of fill before it must be closed, then it can be measured and recognized on that basis. An example of usage might include a pump that has an estimated usage of 30,000 hours before it fails. When the rate of usage is known, it can be recognized accordingly.

For RCRA sites, the total amount of the liability is recognized at the beginning.

Next we examine internal control.

Internal Control

What is internal control – as related to environmental liabilities?

It's a process designed to provide reasonable assurance regarding the achievement of objectives related to reliability of financial reporting, compliance with laws and regulations, and effectiveness and efficiency of operations.

Internal control as related to environmental liability is broadly defined as a process, effected by management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives related to the:

- reliability of financial reporting
- compliance with applicable laws and regulations
- effectiveness and efficiency of operations.

These three categories or types of internal control are achieved through what GAO terms the five standards for effective internal control which we examine further in a few minutes. During the Internal Control Phase of an audit, auditors examine the internal control program to determine if it is effective. As part of the examination, the auditor assesses risk control and determines the nature, timing, and extent of the tests. The types of controls that an auditor tests are exactly what we just discussed, that is financial reporting, compliance, and operations.

Let's review these three types of internal control.

Internal Control (cont.)

Types of Internal Control

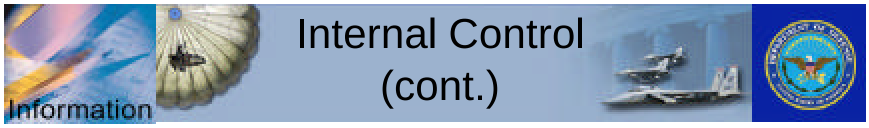
- **Financial reporting internal control**
  - **Ensure that transactions are properly recorded, processed, and summarized**
  - **Safeguard assets against loss from unauthorized acquisition, use, or disposition**
- **Compliance internal control**
  - **Ensure compliance with policies and procedures for managing and controlling appropriated funds**
- **Operations internal control**
  - **Strive to maintain the effectiveness and efficiency of policies and procedures are in place to carry out the organizational mission**
  - **Conduct reviews to ensure that data is not inappropriately manipulated**

The purpose of internal control for financial reporting is to ensure that transactions, like cost estimates, are properly recorded, processed, and summarized. Auditors look to see that Generally Accepted Accounting Principles (GAAP) are applied to transactions. Environmental liability transactions, like estimates, are the basis of the information contained on the Balance Sheet and Note 14. Internal control for financial reporting safeguards assets against losses from unauthorized acquisitions, use, or disposition. An example of internal control is the requirement for separation of duties.

Internal control for compliance looks to the laws, such as the CFO Act and the Federal Financial Management Improvement Act (FFMIA), with respect to budget authority, as well as other applicable laws and regulations that have a material effect on financial statements. Budget compliance control includes management's policies and procedures for managing and controlling the use of appropriated funds received through budget authority. Budget compliance controls that govern budget authority are included in the internal control information covered in the Office of Management and Budget (OMB) audit guidance.

Organizations need to have published policies and procedures, local guidance, and Standard Operating Procedures (SOPs) that serve as a framework for management to carry out organizational objectives, such as planning, productivity, programming, quality control, economy, efficiency, and effectiveness. The auditors' review ensures that these controls provide reasonable certainty that the entity achieves its mission, and maintains quality standards in an effective and efficient manner.

The 2004 PAR indicates the latest audit findings regarding the Department's financial statements.



Internal Control (cont.)

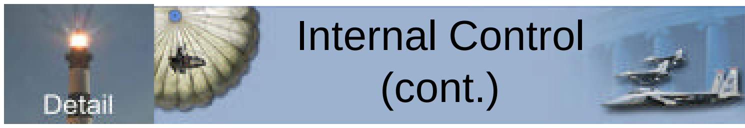
Management control process is required to:

- **Provide the entire universe of environmental liabilities from which DERP and non-DERP are then classified**
- **Ensure that the Component has accounted for all non-DERP environmental liabilities**
- **Be used in developing environmental liability estimates**

In order to know whether all of the environmental liabilities have been captured, develop and document a management control process. This end-to-end plan should be developed at the lowest practical level, on a geographic, facility, or other logical basis.

The overall objective of this process is to ensure that no type of environmental liability is overlooked.

Next we examine the basis of liability estimates.



Internal Control (cont.)

Material Weakness: Environmental Liabilities

Environmental Liabilities	Guidance and audit trails are insufficient. The inventory of ranges and operational activities (landfills, open burning pits, etc.) is incomplete.	The Department issued guidance for closed sites in October 2002 and continues to issue guidance for on-going operations. Inventories of operational and non-operational ranges are complete. Additional review and validation is needed to ensure audit trails are sufficient.

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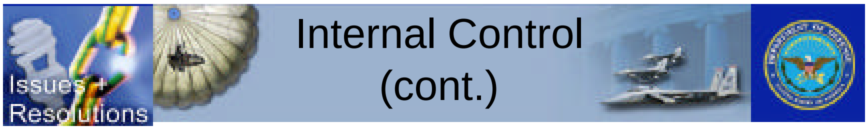
According to the 2004 PAR, a material weakness exists within the reported environmental liabilities concerning the sufficiency of guidance and audit trails. The PAR also reports that inventory of ranges and operational activities (landfills, open burning pits, etc.) is incomplete. To correct these deficiencies, the Department issued guidance for closed sites in October 2002 and continues to issue guidance for ongoing operations. Inventories of operational and non-operational ranges are complete; however, additional review and validation is needed to ensure audit trails are sufficient.

Completed milestones:

- Provided guidance to accomplish an initial operational range inventory.
- Reported the operational range inventory to Congress in February of FY 2004.
- Completed a real property inventory business process reengineering and presented the concept for DoD-wide review.
- Revised the Financial Management Regulation for liability recognition and reporting for operational ranges and munitions response areas.
- Published the directive entitled “Sustainment of Ranges and Operating Areas,” that requires reporting of environmental remediation liabilities.
- Issued planning guidance that requires the assessment of environmental condition of the operational ranges.

The Department had changes in estimates resulting from overlooked or previously unknown contaminants, better site characterization with sampling, and re-estimation based on different assumptions, lessons learned, and advances in technology. Future changes may be attributed to changes in laws and regulations, and changes in agreements with regulatory agencies.

Let’s look at the planned milestones for 2005 and beyond.



Internal Control (cont.)

Problems and Solutions for FY 2005

Policy and guidance lacking:

- **Non-DERP guidance planned for issue in 1st Quarter FY06**

Continuing weakness and audit finding:

- **Documentation**
  - **Audit trail**
  - **Management reviews**

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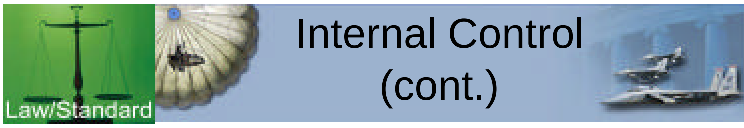
Shown on the slide are a couple of significant problems that we can correct. For example, staffing of the non-DERP guidance is nearing completion. It issuance will enhance the Department's treatment of environmental liabilities by providing a common source guidance for those working non-DERP liabilities.

Audits have continually revealed weaknesses in environmental liability documentation. Knowledge of what the auditors need to see regarding audit trails and management reviews will help solve this concern. The positive efforts of all entities will result in an unqualified opinion on the annually audited financial statements.

Let's examine some of the laws and guidance related to internal control.



Internal Control (cont.)

The FMFIA requires that:

- **Obligations and costs comply with law**
- **Assets are safeguarded against waste, loss, unauthorized use, or misappropriation**
- **Revenues and expenditures are properly recorded and accounted for**

To meet the law's requirements, ensure that resources are used:

- **Consistent with mission**
- **In compliance with applicable laws, directives, and instructions**
- **With minimal potential for waste, fraud, and mismanagement**

The FMFIA also requires, as part of the annually audited financial statements, that a statement be included regarding the conformance of the agency's accounting system with applicable standards.

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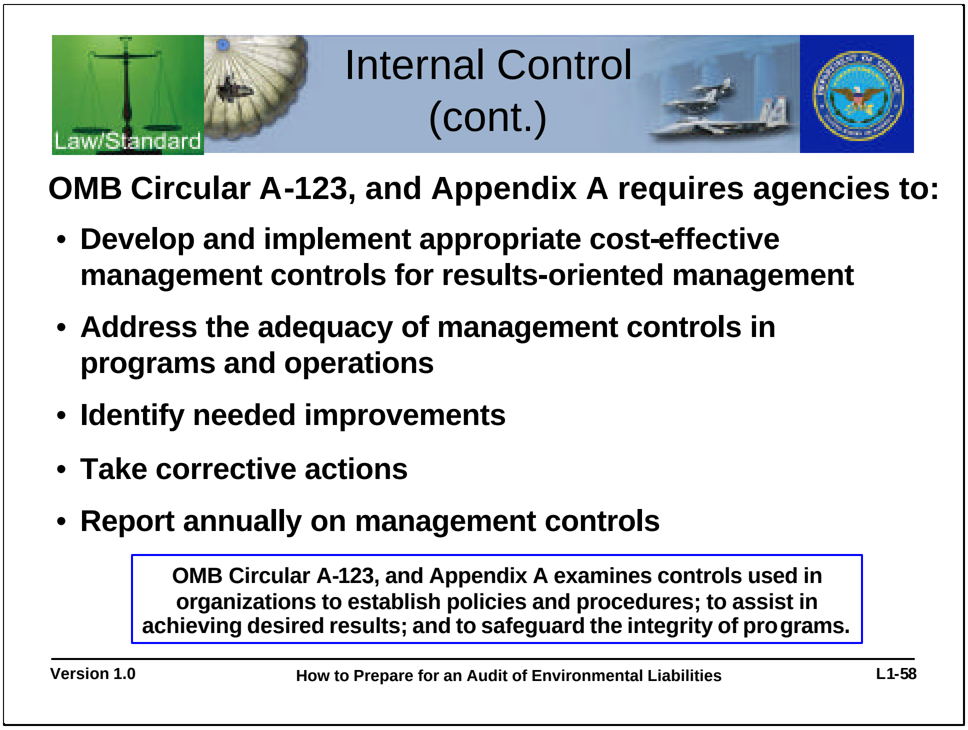
The Federal Managers Financial Integrity Act (FMFIA) requires federal agencies to establish internal control programs to ensure proper accounting and that safeguards are in place to prevent waste, loss, or unauthorized use. The Department has published internal control policy and procedures in DoD Directive (DoDD) 5010.38 and DoD Instruction (DoDI) 5010.40 to help meet this requirement. Each individual must ensure that resources are used consistent with our mission and are in compliance with all laws and regulations to allow minimal potential for waste, fraud, and mismanagement.

This act also requires, as part of the annually audited financial statements, that a statement be included regarding the conformance of the agency's accounting system with applicable standards.

Internal control must assure management that procedures are in place to prevent non-compliance with the law.

Next we look at the OMB Circular A-123, and Appendix A.



As part of the FMFIA implementation, the OMB distributed Circular A-123, Management's Responsibility for Internal Control, and Appendix A, Internal Control Over Financial Reporting, to provide specific requirements for assessing and reporting on controls. This circular emphasizes management accountability to improve effectiveness of federal programs. The circular requires agencies to:

- develop and implement appropriate cost-effective management controls for results-oriented management
- assess the adequacy of management controls in programs and operations
- identify needed improvements
- take corrective actions
- report annually on management controls.

On the next slide, we review some of the activities for which internal control is designed.

Internal Control (cont.)

Law/Standard

Examples of environmental liability activities for which internal control is designed:

- **Effective management of the workforce**
- **Controls over information processing**
- **Establishment and periodic reviews of performance measures**
- **Segregation of duties**
- **Proper execution of transactions based on proper authority**
- **Accurate and timely recording of transactions or events**
- **Limited access and strict accountability for certain resources and records**
- **Clear documentation for all transactions that is readily available for review**

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Internal control activities are an integral part of planning, implementing, and reviewing. They are essential for proper stewardship and accountability and for achieving effective and efficient results. Control activities should occur at all levels of an entity and include a whole range of activities, such as approvals, authorizations, verifications, reconciliations, performance reviews, security, and the creation and maintenance of appropriate documentation.

Next let's examine an internal control for cost estimate processing.

Internal Control (cont.)

Supervisory Review Check List

Installation Name________________________ Review Date________________________

Estimator Name________________________ Date Estimates Prepared______________

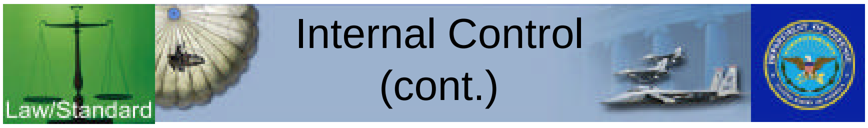
	Yes	No
1. Are sound estimating methodology and reasonable assumptions used?		
2. Did the estimator compare prior year estimates to the current year estimates?		
3. Does the estimate include all relevant phases and costs to complete the cleanup?		
4. Is the estimate consistent with the operational plans of the installation?		
5. Does the estimator have proper qualifications and required training to develop the estimate?		
6. Is there an adequate audit trail to support the estimate?		
7. Is there adequate documentation to support the underlying assumptions used to develop the estimate?		
8. Does the supervisor agree with the underlying assumptions used to develop the estimate?		
9. Is the estimate maintained in the current cost basis?		

Supervisor's Signature______________________________ Date__________________

Note: The above checklist is being used to assess the reasonableness of the installation's estimates and to document supervisory review. The signed checklist reflecting final approval will be maintained with the estimates as part of the audit trail and attached electronically to the data reporting system.

This checklist is a good example of the types of OMB Circular A-123 and Appendix A activities we discussed. In a May 2004, DoD OIG report, supervisory reviews were highlighted as a problem. Of the 719 environmental liability estimates reviewed, only 74 had adequate supporting documentation (Environmental Liabilities Required To Be Reported on Annual Financial Statements, D-2004-080, May 5, 2004).

Let's look at six OMB Circular A-123 and Appendix A implementation issues that were identified by the GAO.



Internal Control (cont.)

OMB Circular A-123 and Appendix A Implementation Issues Identified by GAO

- **Need for supplemental guidance and implementation tools**
- **Need for special attention to:**
  - **Achieve effective and efficient operations**
  - **Comply with laws and regulations**
- **Need for managers to provide strong support for internal control**
- **Need for agencies to strike a balance between costs and benefits , while achieving an appropriate level of internal control**
- **Need for management testing of internal control to determine:**
  - **Their soundness**
  - **Whether they are being adhered to**
  - **Whether corrective action is necessary**
- **Need for personal accountability, starting at top and cascading through organization**

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Internal control provides reasonable assurance that the Department is achieving the desired results through effective stewardship of public resources. It is based on what the GAO terms fundamental concepts. That is, internal control is not a single, isolated event, but rather a continuous series of actions and activities that are part of the entire day-to-day operation.

People are at the center of effective internal control. While management sets the objectives, the staff makes it happen.

Finally, cost and benefit must be judged when designing and implementing internal control. The cost to provide absolute assurance is simply prohibitive in most instances.

Additionally, there are factors outside the control or influence of management that can affect the organization’s ability to meet its goals. Even things like human mistakes, judgment errors, and acts of collusion can affect meeting objectives.

Let’s look at GAO’s standards for internal control.

Internal Control (cont.)

GAO Standards for Internal Control

- **Control Environment**
- **Risk Assessment**
- **Control Activities**
- **Information and Communications**
- **Monitoring**

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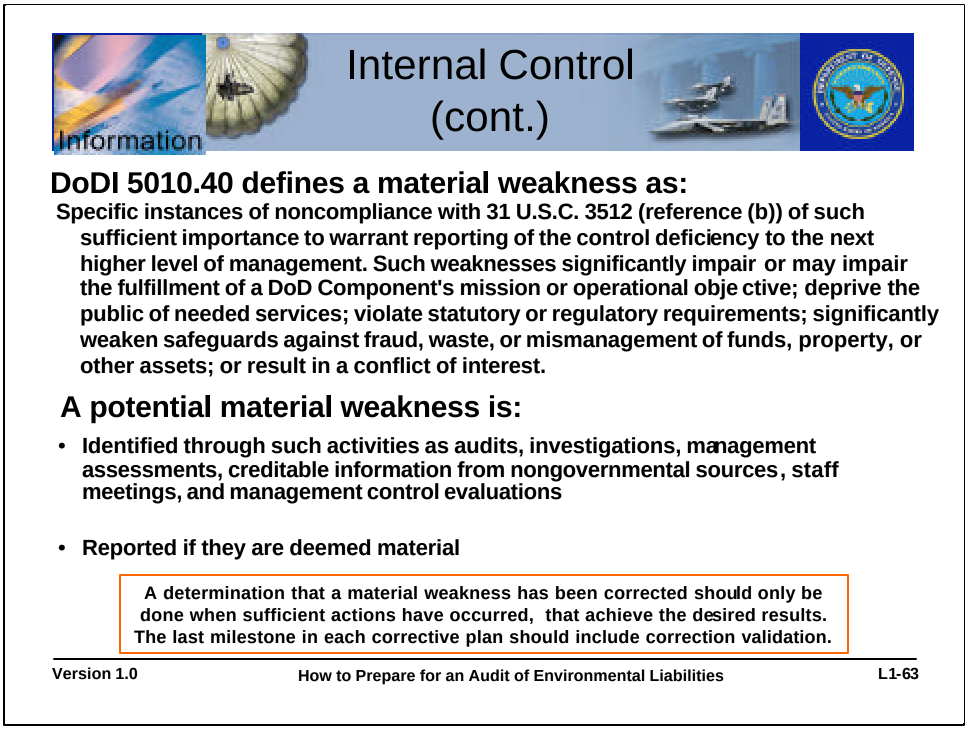
The GAO has established five standards for effective internal control that address the following areas:

- Control Environment – concerned with integrity and ethical values, commitment to competence, organizational structure, human resources policies and practices
- Risk Assessment – identification of internal and external risks associated with program or agency objectives that include estimating the risk's significance, likelihood of occurrence, and plans to manage the risk
- Control Activities – policies and procedures established to achieve objectives such as authorization and approvals, access controls, verification and reconciliations, documentation and audit trails, and supervision
- Information and Communications – imperative for success, both up and down the chain, and directly affects decision-making ability
- Monitoring – ongoing activities and separate evaluations, it ensures that audit findings are quickly and adequately resolved.

Let's examine the Department's guidance.



In order to be classified as a material weakness, it must satisfy three conditions. It must:

- result from internal control that is not in place, not used, or not adequate
- be reportable to the next higher level of management
- be corrected by the Component managers in a timely and effective manner.

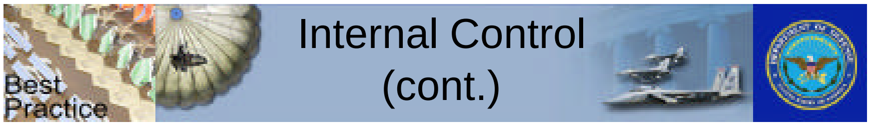
According to DoDI 5010.40, the ultimate determination of a material weakness resides with management. To review the status of all on-going material weaknesses for the Department, review the latest PAR.

A potential material weakness is one that is:

- identified through such activities as audits, investigations, management assessments, creditable information from nongovernmental sources, staff meetings, and management control evaluations
- reported if they are deemed material.

Finally, a determination that a material weakness has been corrected should only be done when sufficient actions have occurred that achieve the desired results. The last milestone in each corrective plan should include correction validation.

Let's look at good practices to ensure that you have knowledge of all relevant environmental liabilities.



Internal Control (cont.)

Management Best Practices

- **Inventory of all sites to determine environmental liabilities and validate site inventories with General PP&E records**
- **Ensure that a permanent, unique identifier is assigned to each site**
- **Track environmental actions at sites, determine the status of each site, and track fiscal information used to support financial statements**
- **Produce consistent and logical reports**
- **Ensure that data is complete, up-to-date, and properly documented**

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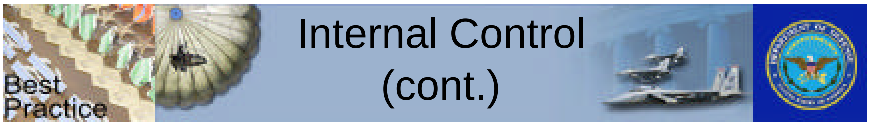
To help determine whether a Component has produced estimates for all environmental liabilities that may be material to the financial statements, program managers consider how the Components conduct business, the circumstances in which they operate, and any new accounting pronouncements and other factors that may have a bearing.

Components must maintain a database containing the site inventory and associated estimates in order to track and update changes as needed. This inventory must be validated against General PP&E records at least annually (DoDFMR, Volume 4, Chapter 13).

Another internal control related to environmental liabilities is the qualifications of an estimator. Let’s discuss those next.



Internal Control (cont.)

Best practices of estimator qualifications is training and experience in the following areas:

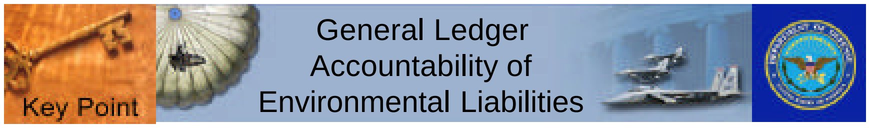
- **General environmental**
- **Environmental program related to the type of estimates being developed**
- **Project planning and management**
  - **Accepted practices in preparing cost estimates**
  - **Use of any cost estimating technique used**
- **Accounting/auditing policies**

An example of internal control in the Department is reflected in the Components requirement to establish specific personnel qualifications for staff engaged in the development of cost estimates or preparation of environmental restoration liability reports.

The minimum qualification for an estimator is training and experience in the following areas:

- General environmental
- Environmental program related to the type of estimates being developed
- Project planning and management
  - Accepted practices in preparing cost estimates
  - Use of any cost estimating technique used
- Accounting/auditing policies.

Now let's talk about accounting for environmental liabilities.



Accounting for environmental liabilities is based on the DoDFMR, Volume 4, Chapter 13.

This chapter implemented the provisions of the SFFAS No. 5, Accounting for Liabilities of the Federal Government, and SFFAS No. 6, Accounting for Property, Plant and Equipment.

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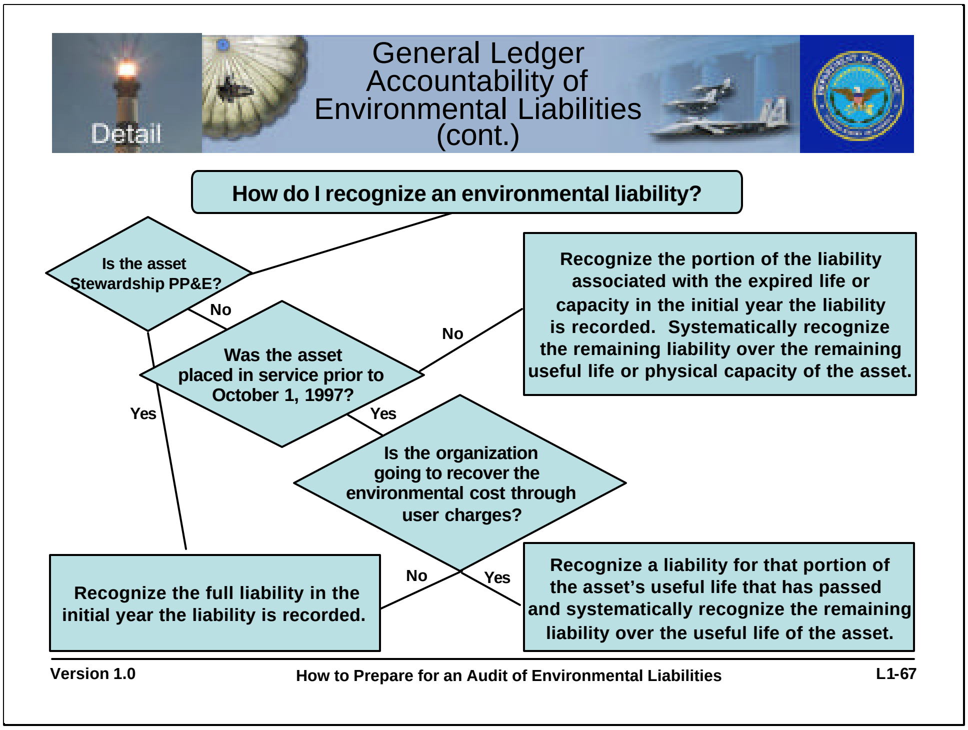
The OUSD(C) issues the DoDFMR which contains the Department's financial management policies and procedures.

Volume 4, Chapter 13, of the DoDFMR, prescribes the Department's accounting policy for measuring, recognizing, and disclosing environmental liabilities. The policies and procedures prescribed apply to all environmental liabilities regardless of the funding source and whether funds are available.

The chapter implements applicable provisions of SFFAS No. 5, Accounting for Liabilities of the Federal Government, and SFFAS No. 6, Accounting for Property, Plant, and Equipment (PP&E), as well as other applicable guidance. It should be read by all to ensure that any updated information is incorporated in SOPs.

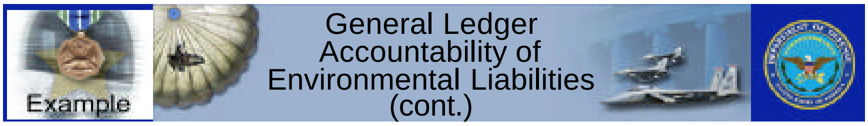
Let's look at how to properly charge environmental liability estimates.



As we walk through the steps to recognize an environmental liability, notice the first question asks if the asset is Stewardship PP&E. Stewardship PP&E are those assets that are set aside for the use and enjoyment of present and future generations. The government doesn't expect to use Stewardship Land to meet its obligations, unlike the assets listed in the Balance Sheet. It is measured in non-financial units such as acres of land and lakes, miles of parkways, and miles of wild and scenic rivers.

Continue to step through the questions to see how to recognize various situations.

Now that we have examined the steps to recognize an environmental liability, let's review an example of recognition based on capacity.



Example

A landfill with a capacity of 1 million tons has a final estimate of $2 million disposal costs. If 100 thousand tons of capacity has been used thus far, and $175 thousand was previously recognized as an expense, an accrual liability of $25 thousand would be recognized in the current year with an offsetting expense. The computation is:

Assumptions: This is General PP&E and there are no user fees.

Calculation: ($2 million X (100 thousand tons/1 million tons)) - $175 thousand = $25 thousand

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Earlier, in our discussion, we learned that liabilities are recognized in a systematic way to account for use of their physical capacity or just simply based on their useful life. This latter method is similar to depreciation expense, in that the total liability is divided by the useful life and incrementally recognized in the financial statements. We also said that for RCRA corrective action sites, the total amount of the liability is recognized at the beginning.

The incremental charge is computed by dividing the total estimated capacity by the capacity used, and then multiplying that by the final estimated cost less any previously recognized expense.

Next we examine some sources associated with environmental liabilities.

General Ledger Accountability of Environmental Liabilities (cont.)

Estimated environmental restoration costs for General PP&E and Stewardship Land are recognized as an expense and a liability is established. The liability is then reduced, as restoration costs are paid. Let's examine the basic accounting entries for cleanup costs.

Dr 6800 Future Funded Expenses
Cr 2995 Estimated Cleanup Cost Liability

Dr 2995 Estimated Cleanup Cost Liability
Dr 6100 Operating Expenses/Program Costs
Cr 2110 Accounts Payable
Cr 6800 Future Funded Expenses

Dr 4610 Allotments – Realized Resources
Dr 4801 Undelivered Orders – Obligations, Unpaid
Cr 4901 Delivered Orders – Obligations, Unpaid

Dr 3107 Unexpended Appropriations – Used
Cr 5700 Expended Appropriations

Estimated environmental restoration costs for General PP&E and Stewardship Land are recognized as an expense and a liability is established. The liability is then reduced, as restoration costs are paid. Cleanup costs for general PP&E are allocated to operating periods in a systematic and rational manner, that must result in the accumulation of the total cleanup cost liability at the time when the PP&E ceases operation. There are two methods to allocate the cleanup costs:

- physical capacity of the associated PP&E – if applicable or estimable
- accrued over the useful life of the associated PP&E.

The first set of entries (Accounts 6800 and 2995) record the current period liability for cost to be funded in the future. This entry is also applicable for the systematically recognized portions of environmental liabilities.

The remaining entries record previously estimated cleanup costs that are due and payable for receipt of goods or services that have not been paid. You may note that the last two entries (Accounts 3107 and 5700) are used if funded by a direct appropriation.

Appendix D contains the accounting entries from the DoDFMR, Volume 4, Chapter 13, Table 13-1, for the complete transaction from liability recognition to expense closure.

Let's summarize what we've learned in this lesson.

In this lesson, you examined the laws and regulations that impact the documentation requirements for environmental liabilities. You learned about liabilities and environmental liabilities and that to become a liability, the cost must be probable, reasonably estimable, and must have already occurred.

You reviewed the financial statements with particular attention to the Balance Sheet. For these you learned about the format including Assets, Liabilities, and Net Position. You learned about the notes that support the Balance Sheet, and found that when an environmental liability is disclosed or recognized, it is found in Note 14.

You followed steps to differentiate between DERP and non-DERP and looked at the documentation requirements. You learned about internal control and that the OMB Circular A-123 and Appendix A requires entities to make an annual report on controls. You reviewed some accounting related to the liabilities and saw there are two methods used to recognize liabilities – incrementally, or all at once.

And finally, you discovered the steps to recognize an environmental liability.

The following slides list references available for additional information.

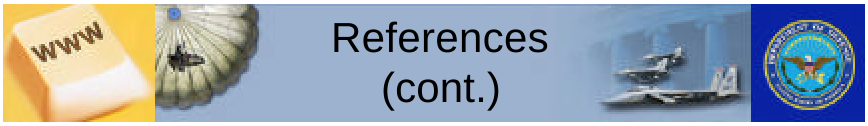
References

DoDFMR, Volume 4, Chapters 12, 13, and 14 and PAR:
http://www.dod.mil/comptroller/fmr/

SFFAS No. 5, No. 6, and No. 12:
http://www.fasab.gov/standards.html

Federal Financial Accounting and Auditing Technical Release No. 2: http://www.fasab.gov/aapc/technicl.html

GAO/PCIE FAM:
http://www.gao.gov/special.pubs/gaopcie/



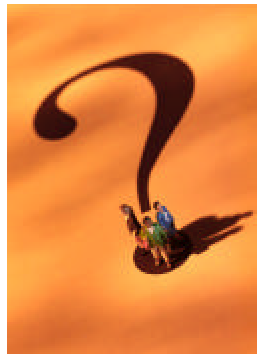
References (cont.)

DoD OUSD AT&L Management Guidance For Recognizing, Measuring, and Reporting, Non-DERP Environmental Disposal and Closure Liabilities (link currently not available)

OMB Circular A-123, and Appendix A: http://www.whitehouse.gov/omb/circulars/a123/a123.html

DoD Base Structure Report, 2004 Baseline: http://www.defenselink.mil/pubs/20040910_2004BaseStructureReport.pdf

Questions



Before we move on to Lesson 2, Documenting Transactions for Environmental Liabilities, do you have any questions on the material covered in this lesson?

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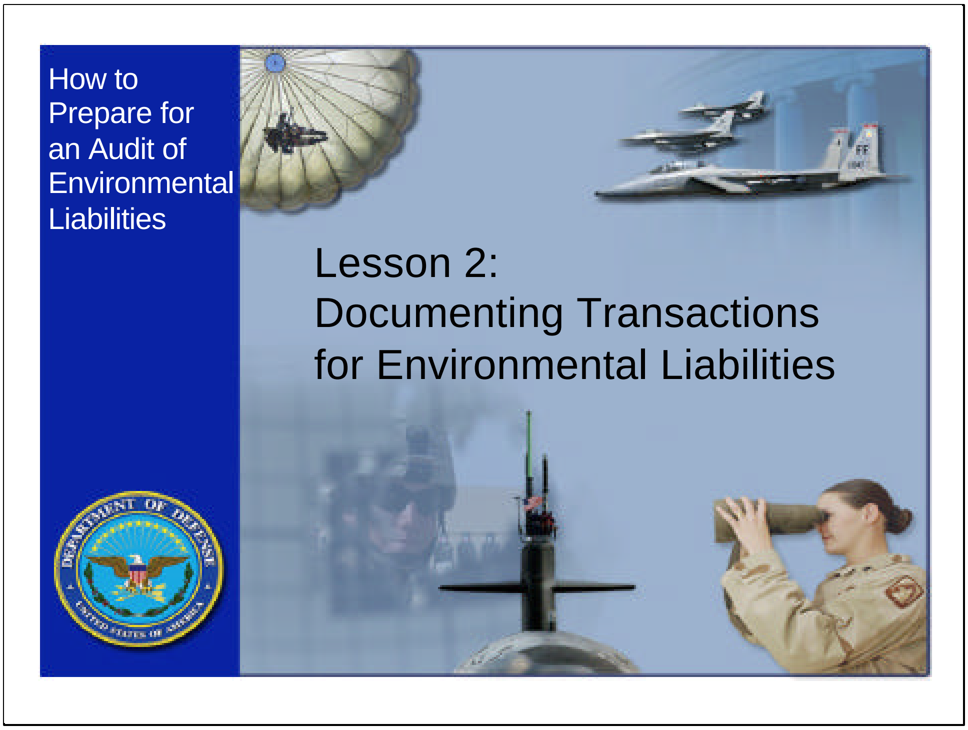

In Lesson 2, we discuss documenting transactions for environmental liabilities.

One of the more important points you should take away from this lesson is in regard to the transactions referenced in the lesson title.

While we may speak of transactions relative to various events, one that is important to documenting and accounting for environmental liabilities refers to cost estimates.

Let's discuss the lesson objective.

Lesson Objective

Upon successful completion of this lesson, you will be able to explain and recognize supporting documentation for environmental liabilities.

In this lesson, you will learn to understand and recognize supporting documentation for environmental liabilities. We will discuss the various guidance that requires supporting documentation to the financial statements and how you can know whether your documentation is sufficient for that purpose.

This is important because auditors will ultimately want to review supporting documentation from the financial statements to the transaction or event source. Better supporting documentation also means more reliable financial data when establishing budgetary requests.

Let's look at the lesson topics next.

This lesson contains the following topics:

- **Types of Supporting Documentation**
- **Documentation for Engineering Estimates of Liabilities**
- **Audit Trails**
- **Electronic Document Access**

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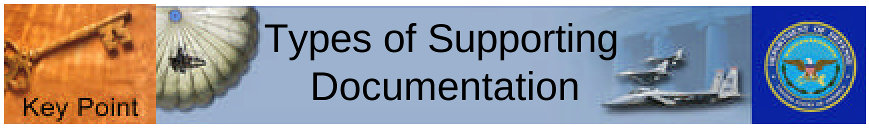
In this lesson, we step through a flowchart to help you examine what to look for to determine an environmental liability.

Then we move on to look at the types of supporting documentation associated with environmental liabilities and that documentation specific to engineering estimates of liabilities.

We examine what constitutes an audit trail and examine its role in the production of financial statements that produce an unqualified audit opinion.

We finish the lesson with a short discussion on electronic documents.



Types of Supporting Documentation

Environmental cost estimates are used for reporting environmental liabilities on the Department's financial statements.

Environmental liabilities are not subject to availability of funds.

Organizations preparing estimates must retain adequate documentation to identify:

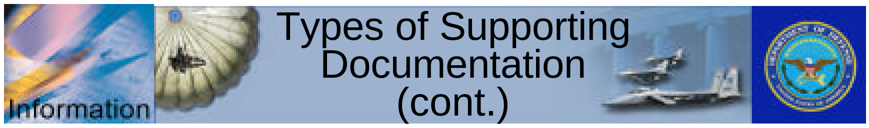
- **Data sources**
- **Estimating methods**
- **Rationale used**
- **Management review**

Although environmental cost estimators normally prepare estimates for budgetary requirements, the Department also used these estimates to report environmental liabilities on the financial statements. When used to support environmental liabilities on the financial statements, the estimates become financial support documents that must comply with the rules established in the Department of Defense Financial Management Regulation (DoDFMR).

The preparation of cost estimates may involve the application of specialized methods, accumulation and study of Historical Costs, and the conduct of technical analyses. Organizations that prepare cost estimates must retain adequate documentation to identify data sources, estimating method accreditation (including parametric models), and rationale used.

Documentation of management reviews also must be retained. Any estimate produced must be based on site specific information, engineering estimates, or cost models validated in accordance with the DoD Instruction (DoDI) 5000.61, DoD Modeling and Simulation (M&S) Verification, Validation, and Accreditation (V, V&A).

Let's look at documentation more closely.



Types of Supporting Documentation (cont.)

Supporting documentation is evidential matter consisting of accounting data and all corroborating information.

The numbers on the financial statements must be provable and the supporting documentation is that proof!

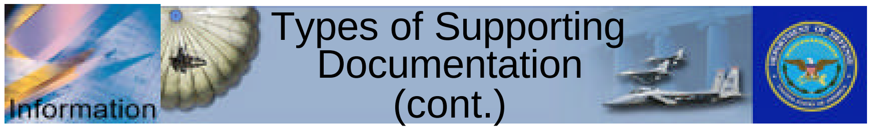
> **The Government Accountability Office (GAO) Yellow Book requires that relevant, sufficient, and competent evidence be obtained through inspection, observation, inquiries, and confirmation, to afford a reasonable basis for an opinion regarding the financial statements being audited.**

Before we can talk about types of supporting documentation, let's first understand what supporting documentation is. Documentation consists of hard or electronic copies of original source documents. It is considered competent when it is relevant, sufficient, and reliable; terms that auditors commonly used when conducting an audit.

Relevant means that the evidential matter relates to the specific audit objective being tested and that it has a logical relationship to the findings and conclusions it is used to support. Sufficient indicates that the audit evidence is complete, adequate, convincing, and would lead another auditor to form the same conclusions. Reliable refers to whether the evidence signals the true state of the assertion or audit objective, and in the auditor's opinion, it is valid, factual, objective, and supportable.

The numbers on the financial statements must be provable, and supporting documentation is that proof. Every entry to record an environmental liability financial transaction requires supporting documentation. Each must be supported by source documents that can substantiate the Component's assertion of environmental liabilities.

Let's continue with the types of evidential matter that auditors review.



Types of Supporting Documentation (cont.)

Types of Evidential Matter

- **Physical – obtained through direct inspection or observation**
- **Documentary – laws, regulations, cost estimates, contracts, inventory reports, and supporting documentation**
- **Testimonial – inquiries, interviews, and questionnaires**
- **Analytical – statistical sampling, comparisons, and ratios**

Example

Management makes an assertion that the environmental liabilities are recorded correctly on the financial statements. To verify, the auditors review the cost estimates, including all evidence, to support how the estimate was derived.

During an audit, auditors use evidential matter to form an opinion regarding the agency's financial statements. The auditors develop audit objectives based on the assertions made by management and a review of the evidential matter that includes:

- physical evidential matter obtained through direct inspection or observation
- documentary evidential matter including laws, regulations, cost estimates, contracts, inventory reports, purchase orders, and other supporting documentation
- testimonial evidential matter including inquiries, interviews, and questionnaires
- analytical evidential matter including statistical sampling, comparisons, and ratios.

The auditors form their opinion on financial statements by obtaining and evaluating evidential matter including supporting documentation. For example, management makes an assertion that the environmental liabilities are recorded correctly in the financial statements. The auditors review this supporting documentation, such as the cost estimates including all evidence, to verify the estimate derived.

Let's take a look at other typical supporting documentation that should be available.

Types of Supporting Documentation (cont.)

Example Documentation

- Cost estimates and corroborating documentation with management reviews
- Permits and approvals
- Contracts, invoices, and disbursement documents
- DD Forms 1354, Transfer and Acceptance of Military Real Property
- Engineering (ENG) Forms 3013, Work Order/Completion Record
- Work orders
- Other third-party documentation

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Supporting documentation takes many forms. It may be cost estimates, contract packages, and any other documentation represented by the numbers found on the financial statements. These numbers are management's assertions about the various programs reflected in the financial statements and are based on the numerous transactions that take place throughout the year. The importance of each piece of supporting documentation cannot be overstated.

The kinds of documentation that must remain available is based on the support it provides. For example, if an estimator uses a contract proposal as a basis for an estimate, then the estimator should ensure a copy of the proposal is accessible for an auditor to verify the estimate.

Documentation should be maintained at point of origin (installation) and attached electronically to the data reporting systems (when possible). It is imperative that the documentation match what is reported in the data reporting systems.

The guidance that identifies document retention requirements is shown on the next slide.

Law/Standard

Types of Supporting Documentation (cont.)

Requirements for document retention are established by:

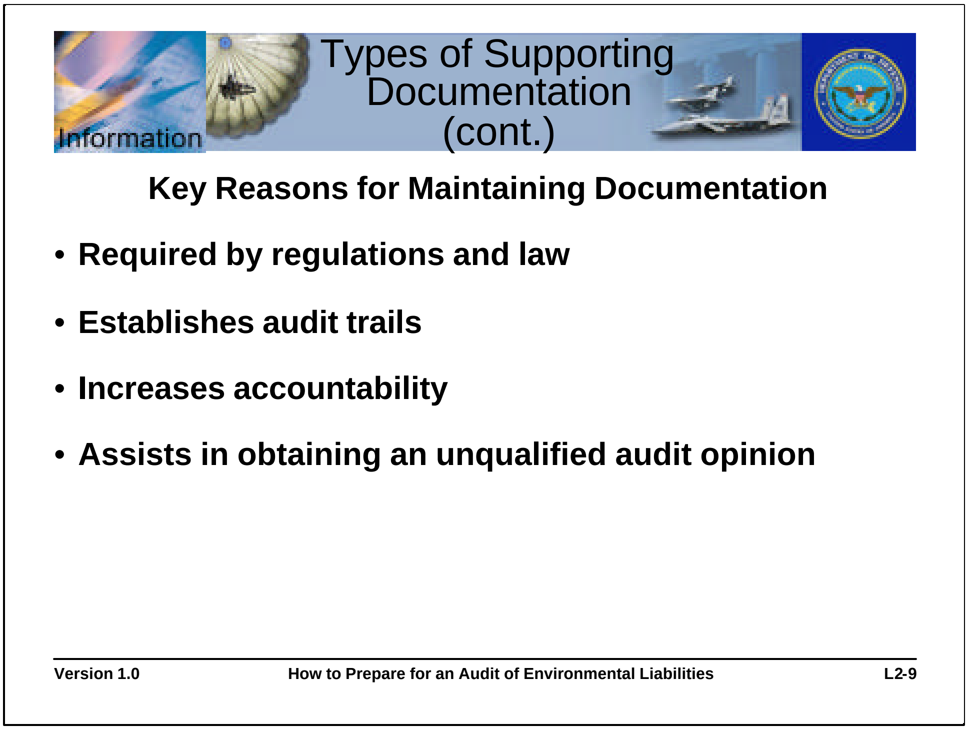
- **U.S. National Archives and Records Administration (NARA) – General Records Schedule (GRS)**
- **Agency policies**
- **DoDFMR, Volume 1, Chapter 9, Financial Records Retention**
- **Defense Finance and Accounting Service (DFAS)**

Specific guidance for maintaining records is contained in the DoDFMR, National Archives and Records Administration (NARA) regulations, and Defense Finance and Accounting Service (DFAS) records management procedures. The DoDFMR Volume 1, Chapter 9, Financial Records Retention, provides guidance for financial records created or received and maintained by all Components. It makes reference to the NARA and their responsibility for providing guidance and assistance for the management and disposition of records.

Documentation should be maintained in a readily available location during the applicable retention period, to permit the validation of information pertaining to the liability. The Department reports liabilities on its Balance Sheet.

The NARA sets policy and establishes standards, procedures, and techniques for the disposition of all federal records in accordance with 44 United States Code (U.S.C.), Chapters 21, 29, 31, and 33. The head of each agency is required to establish and maintain a records disposition program. Each agency established policies to meet the requirements of the DoDFMR and NARA. For example, the DFAS 5015.2-R, Records Management Program, applies to all DFAS business lines, corporate elements, and records maintained by contractor personnel who have engaged in formal agreements with DFAS.

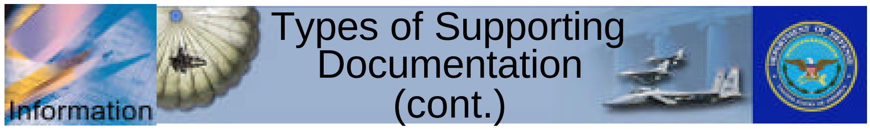
Let’s examine some key reasons why you should retain adequate documentation.



Earlier we talked about the Government Performance and Results Act (GPRA) in that it was enacted to hold agencies accountable for their program's results. Fiscal accountability is increased when documentation is available to support areas such as establishing standards, defining missions, preparing plans, measuring performance, and identifying performance gaps and performance goals.

The Office of Management and Budget (OMB) Circular A-123, and Appendix A, Internal Control Over Financial Reporting, strengthened the requirement for conducting management's assessment of internal control. When audit trails for financial transactions are established, accountability and effectiveness of operations are increased. Supporting documentation that is relevant, sufficient, and competent, is necessary to afford a reasonable basis for an unqualified audit opinion. Most of the auditor's work involves obtaining and evaluating evidential matter to test the fair presentation of your financial statements.

Leased properties are another source of potential liability, as shown on the next slide.



Types of Supporting Documentation (cont.)

Environmental liabilities may be associated with leases, whether capitalized or expensed.

Supporting documentation for environmental liabilities is required whether the cause is capitalized or expensed Property, Plant, and Equipment (PP&E).

Examples include:

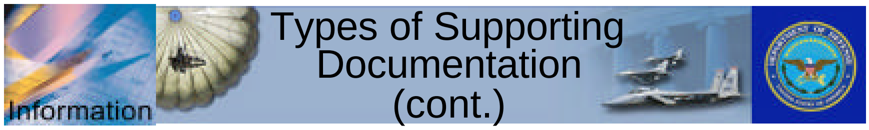
- **FUDS right of entry**
- **Leases**
- **Deeds**

Environmental liabilities may be associated with all property under the jurisdiction of the Secretary of Defense (SecDEF). This includes each facility or site owned by, leased to, or otherwise possessed by the U.S. and under the jurisdiction of the SecDEF.

Supporting documentation for Property, Plant, and Equipment (PP&E) that does not meet the Department's capitalization threshold of $100,000, and is therefore expensed, must still be recorded in property accountability records (or systems) for control purposes, if the cost is equal to or greater than $5,000. Also, PP&E that is considered sensitive and/or subject to pilferage, regardless of the cost, must be recorded in property accountability records.

Records must document the identity and maintain accountability for capitalized additions and improvements to PP&E. Lease improvement documentation must also provide information to identify and account for leased PP&E, no matter if it was acquired by capital lease or operating lease, or whether the value exceeds the DoD capitalization threshold. Capital leases are considered equivalent to a purchase, while operating leases cover the use of an asset for a period of time and are treated by the lessee as periodic expenses.

Let's look at changes to environmental liability documentation.



Types of Supporting Documentation (cont.)

Cost estimates of environmental restoration liabilities must be revised when there is a material changes from the prior year:

- **Changes must be fully documented**
- **Revised estimate forwarded through the Component to OUSD(I&E) for inclusion in financial statements**
- **Nature of change must be disclosed**

Material change is defined as a change, up or down, of more than 10 percent from prior year ending balance.

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Revision of estimates is necessary when material changes occur. They must be fully documented and the revised estimates forwarded up the channel to be included in the Department’s annual financial statements. The nature of the change must be disclosed in the financial statement notes. The term material changes is intended to mean an increase or decrease of 10 percent or more from the previous year’s reported estimate.

Let’s continue with our look at adjustments to environmental documentation.

Types of Supporting Documentation (cont.)

Adequate documentation for cost estimate change:

- **State the reason for the change in the cost estimate**
- **Rationale and justification for the adjustments**
- **Details – numbers, amounts, other facts**
- **Date of the adjustments**
- **Name and position of the person approving the adjustments**

The supporting documentation should include the consequences of adjustments by carefully validating adequate support to the adjustment. What is needed is written documentation that is sufficiently detailed, so that it provides an audit trail to the source that requires the adjustment.

Document the reason for a change in the cost estimate such as caused by:

- change in scope
- new contamination
- management review
- new technology
- regulatory requirement.

This documentation ought to include the rationale and justification for the adjustment, detailed numbers and dollar amounts of errors or conditions that are related to the transaction or record that are proposed for adjustment, the date of the adjustment, and the name and position of the individual approving the adjustment. Changes from the prior year of at least 10% must be documented in the current year estimate update. This is an area that is apt to cause problems, as it is not a routine event and care should be given to the verification of supporting documentation.

Next we look at steps to ensure that you have knowledge of all relevant environmental liabilities.

Key Point

Documentation for Engineering Estimates of Liabilities

Estimates of Environmental Liabilities

- **Required annually by the Department**
- **Basis for environmental liabilities**
- **Must comply with the DoDFMR 7000.14-R**
  - **Documentation of data sources**
  - **Method of estimation**
  - **Management review documentation**
- **Subject to audit**
- **Site level reporting is the responsibility of the installation, unless otherwise designated**

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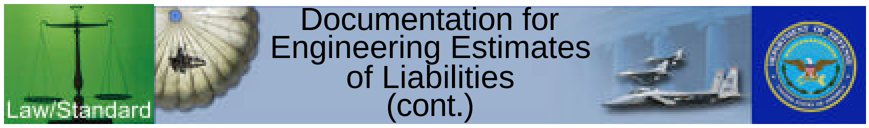
Estimates are required annually by the Department to support assertions of environmental liabilities on the financial statements and to provide the annual report of environmental programs to Congress. Because these estimates are used to support the financial statements, they must comply with the DoDFMR regarding supporting documentation, methods of estimation, and documentation of management reviews.

These estimates are subject to audits and it is the installation's responsibility to develop these estimates and maintain all appropriate documentation. This includes providing knowledge of the whereabouts of other supporting documentation used to create the estimates. All cost estimates reflected in the environmental liability line of the Balance Sheet must be documented. This includes cost data entered at headquarters, major command, or installation level.

Let's turn our attention to the determining factors for a future payment.



The GAO Yellow Book states that estimates must be supported by:

- **Relevant data**
- **Reliable data**
- **Sufficient data**

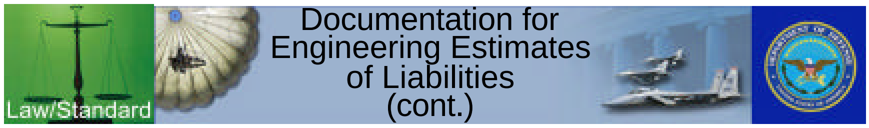
Adequate environmental liability documentation is a collection of pertinent project-related documents that support underlying factors, assumptions, and estimated costs, including background information, disposal or restoration strategy, physical units in the estimate, cost per unit, cost adjustments such as conversion to current year dollars, and significant project changes.

Earlier we learned that the GAO Yellow Book says estimates must be supported by relevant, reliable, and sufficient data, that is, adequate documentation.

When talking about how that relates to engineering estimates of liabilities, we mean adequate documentation is all the pertinent project-related documents that support the estimate.

This includes the assumptions based on engineering judgment, background information, disposal or restoration strategies, physical units in the estimate, cost per unit, and adjustments.

Let’s take a closer look at documentation of assumptions.



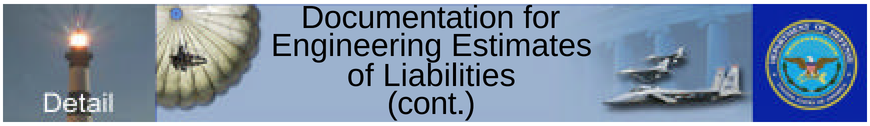
Documentation for Engineering Estimates of Liabilities (cont.)

American Institute of Certified Public Accountants (AICPA) standard AU 342 states that auditors may:

- **Identify controls over the preparation of estimates**
- **Identify the sources of data used in forming the assumptions**
- **Consider additional key factors or alternative assumptions**
- **Evaluate the assumptions for consistency**
- **Analyze historical data used in developing the assumptions**
- **Consider changes in business or industry may cause other factors to become significant to the assumptions**
- **Review documentation of the assumptions**
- **Consider using a specialist regarding certain assumptions**
- **Test the calculations used to translate assumptions into the estimate**

The American Institute of Certified Public Accountants (AICPA) issues auditing standards. AU 342 indicates that in many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may perform when reviewing managements processes:

- Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. Examples of controls include qualification, training, supervisory review, quality control.
- Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests. Examples include Preliminary Assessment/Site Inspection (PA/SI), Record of Decision (ROD), financial statements, historical data, procurement baseline.
- Consider whether there are additional key factors or alternative assumptions about the factors
- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. Example includes industry trends.
- Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose
- Consider whether changes in the business or industry may cause other factors to become significant to the assumptions
- Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions
- Consider using the work of a specialist regarding certain assumptions (Section 336, *Using the Work of a Specialist),* for example, an actuary.
- Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.



Documentation for Engineering Estimates of Liabilities (cont.)

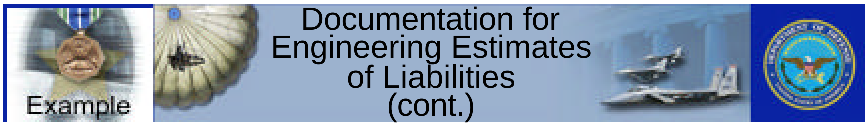
A summary document should contain:

- **Background Information – estimator name, date completed, other pertinent information**
- **Cleanup Methodology – steps needed to complete the project**
- **Assumptions – items that were unknown at the time the estimate was developed, yet necessary to complete the estimate**
- **Physical Aspects/Units – tangible assets of a project such as acres of land and number of monitoring wells**
- **Quantity – amount needed of a particular physical aspect/unit**
- **Cost per Unit – cost to purchase a particular physical aspect/unit**
- **Cost Elements – parts of a particular cost/estimate**
- **Supervisory Review – documented approval of an estimate**
- **Project Changes – documented and approved increase or decrease costs**
- **Cost adjustment – recognition of additional costs or the removal of costs when parts of the project are funded**

In order to facilitate an audit trail, the estimator should develop a summary document that is placed in the estimate file. It should contain information to ensure a complete estimate and one that can withstand an audit. The summary document also should provide a connection between the source documents and the estimate, to facilitate an auditor tracing the various sources of input to the estimate. Specific information contained in the summary document should include:

- Background Information – estimator name, date completed, other pertinent information
- Cleanup Methodology – steps needed to complete the project
- Assumptions – items that were unknown at the time the estimate was developed, yet necessary to complete the estimate
- Physical Aspects/Units – tangible assets of a project such as acres of land and number of monitoring wells
- Quantity – amount needed of a particular physical aspect/unit
- Cost per Unit – cost to purchase a particular physical aspect/unit
- Cost Elements – parts of a particular cost/estimate
- Supervisory Review – documented approval of an estimate
- Project Changes – documented and approved increase or decrease costs
- Cost adjustment – recognition of additional costs or the removal of costs when parts of the project are funded.

An example provided by the Army is shown on the next slide.



Example of a Summary Document

AEDB-R #	SITE TITLE	RRSE	PHASE	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15+	PHASE TOTAL	SITE TOTAL	DESCRIPTION OF WORK	ESTIMATE SOURCE	SUP DOC	ESTIMATOR & DATE PREPARED
FTIRP-19	Oil Sludge Holding Pond	LOW	RA	63											63		50cy of material (sludge and soil), excavation and off site disposal	Feasibility Study	FS 10/03, pgs ES-6, 5-9, Table 2-15	John Brown, 02-Mar-04
			LTM		23	23	23	23	23						115	178	5 years, 4 wells	Feasibility Study	FS 10/03, pgs 5-10, Table 6	John Brown, 02-Mar-04
FTIRP-27	Inactive Landfill Behind Girl Scout Area		RD		72										72		design	RACER		John Brown, 02-Mar-04
			RA			650									650	722	3.5 acres, assumed capping of landfill	RACER	RFI Report 01/04 pg. 3	John Brown, 02-Mar-04
FTIRP-28	Line 800 & Pinkwater Lagoon - Groundwater	HIGH	RI/FS	1903											1,903		RI/FS	RACER	MFR	John Brown, 02-Mar-04
			RD		750										750		design	RACER	MFR	John Brown, 02-Mar-04
			RA			2,000	2,000	2,279							6,279		clear and grub - 2 acres; excavation - 19259 cy; fencing -100ft; install 14 GWM wells; permeable barrier - 3704 cy;	RACER	MFR	John Brown, 02-Mar-04
			LTM						348	348	348	348	348	5,220	6,960	15,892	Annual monitoring; 20 yrs; 30 GWM wells	RACER	MFR	John Brown, 02-Mar-04
FTIRP-30	Former Fuel Station UST's	HIGH	LTM	11	11	12	11	12							57	57	Annual monitoring; 5 yrs; 9 GWM wells	Historical Costs	Contract # DAAA09-02-P-0076	John Brown, 02-Mar-04
FY TOTALS IN THOUSANDS OF				1,977	856	2,685	2,034	2,314	371	348	348	348	348	5,220	16,849	16,849				
POM				1,977	856	2,685	2,034	2,314	371	348	348	348	348							
Difference				0	0	0	0	0	0	0	0	0	0			16,849				
				FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15+						

The Component estimator must establish an audit trail from support documentation to the summary document and vice versa.

Here is an example a summary document developed by the Army that would be incorporated into the Memorandum for Record (MFR) to be placed in the installation's project files. In addition to the information about the estimate, notice the connection to the estimate source and support documentation references.

Let's look at the database number FTIRP-28 for the Pinkwater Lagoon. Notice the various phases that the project has moved through, starting with Remedial Investigation/Feasibility Study, then moving down, Remedial Design, followed by Remedial Action and finally Long Term Management. Notice the estimated costs included beside each of the phases, as well as the site total cost of $15,892,000.

In the next section, we see a short description of the work being performed followed by the estimating source – in this case it was performed in the DoD approved Remedial Action Cost Engineering Requirements (RACER) system. The fact that it was estimated in RACER, provides a certain amount of supporting documentation; however, notice that there are references to MFRs that also help trace (or provide an audit trail) the activity. Finally, this summary document ends with the estimator's name and date prepared.

We mentioned audit trails here, let's look at them more closely.

Audit Trails

The DoDFMR requires that adequate documentation be maintained for an effective audit trail. An audit trail enables the tracing or replicating of a transaction from its source to the resulting record or report, and from the resulting record or report, to the source.

Audit trails refer to cost estimates and other documents, journals, ledgers, worksheets, reports, and statements by which an original transaction can be traced forward to a summarized total, or a summarized total can be exploded backward to the original transaction.

The DoDFMR provides information on the structure of the accounting system, including 13 key accounting requirements.

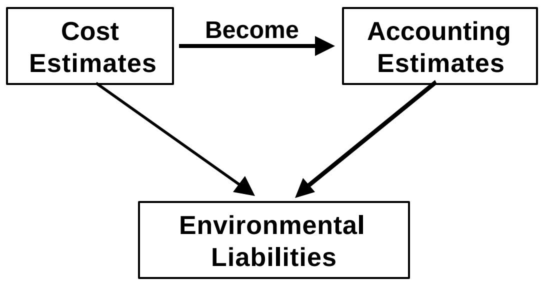
A departure from a key accounting requirement could lead to a material deficiency such as loss of control of resources, impair the DoD mission, allow fraud or other criminal activities to go undetected, create adverse publicity for the Department, or cause violations of statutory requirements (obligations or expenditures in excess of funds).

The Key Accounting Requirement, Number 8, describes that a proper audit trail should allow a transaction to be traced from initiation through processing, to final reports. Source records for an audit trail should include transaction type, record or account involved, amount, processing references, and identification of the preparer and approver of the transaction.

The summary document we just reviewed is a good example of tying it all together, so that it becomes auditable. Audit trails for environmental liabilities must be traceable from the Balance Sheet through Note 14, to the basic supporting documentation used to develop the estimate.

This is true for cost estimates, as shown on the next slide.

Audit Trails (cont.)

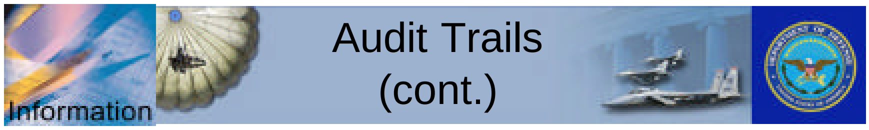


Cost estimates used to support environmental liabilities become accounting estimates used to support environmental liabilities. The cost estimate becomes part of the documentation used to support environmental liabilities stated on the Department's financial statements, it is accounting documentation, and it is subject to the financial rules for audit and retention.

The documentation must contain sufficient information to track a single transaction from its inception to the financial statements and from the financial statements back to the source documents. When the documentation is properly maintained, it establishes an audit trail that is critical during the audit of the financial statements.

A couple of tools that can facilitate understanding the audit trail is to build a checklist or a flowchart.

Let's examine those methods now.



Audit Trails (cont.)

Checklist Development

- **Review Prepared by Client (PBC) list**
- **Flowchart the audit trail**

The DoDFMR requires that adequate documentation be maintained for an effective audit trail.

To build a checklist, we need to establish the documents you use and where they are located. You may want to start by reviewing previous Prepared by Client (PBC) lists, if available. The PBC list is initially prepared by the audit team and provided to the audited entity identifying the auditor's requirements including due dates. The list is used to facilitate the audit process by ensuring coordination with those points of contact the audit team determined they need to see. This includes hard copy documentation, systems, places, people; basically everything that touches the audit trail should be available and ready. Environmental liabilities should be tested for Existence or Completeness at the site long before the auditors arrive.

To gain more insight, it is helpful to develop a flowchart outlining the organization's processes. These flowcharts will point out various documents supporting the organization's activities. Often, the document that creates an accounting event does not originate in an accounting system and could be processed by non-accountants. An example might be a cost estimate that supports the environmental liabilities on the financial statements.

Often difficulty arises because of the various competing responsibilities of accounting and non-accounting management. What must be understood is that reliable documentation to support auditable financial statements is everyone's responsibility and ultimately benefits everyone.

On the next slide we have an example of a PBC list.

Example

Audit Trails (cont.)

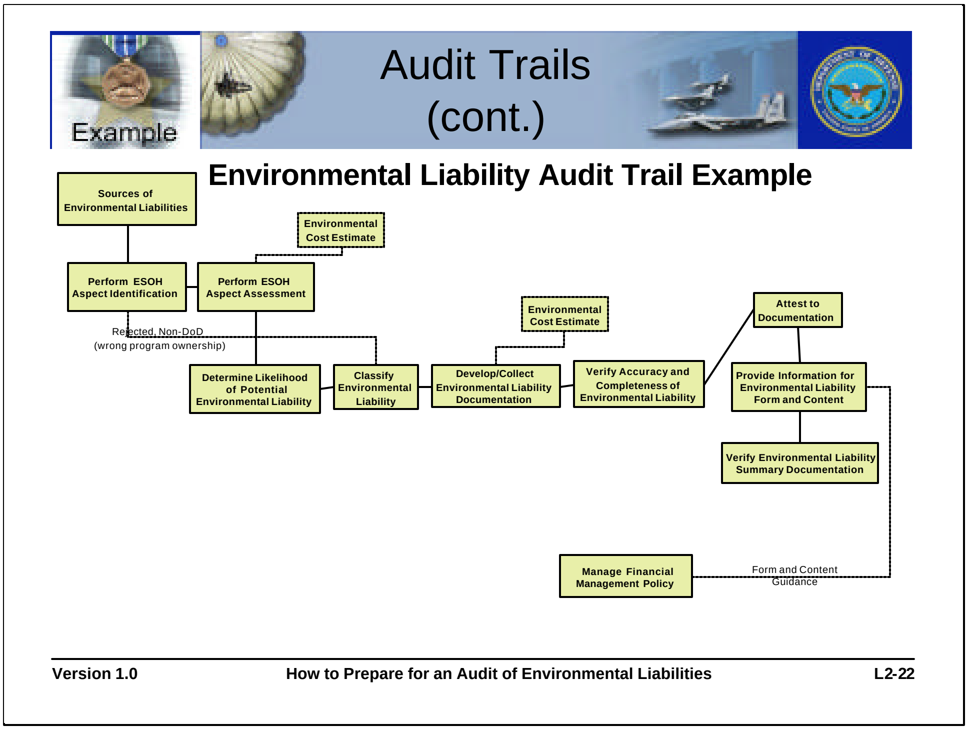
Sample Prepared by Client (PBC) List

Item	Requested Document	Contact and Phone Number	Date Requested	Date Needed	Date Received
	General				
1.	Current version of accounting policies and procedures manual with policies and procedures for Cash and Fund Balance with Treasury, Accounts Receivable, Inventory, Property and Equipment, Advances, Accounts Payable, Accrued Liabilities, and Net Position				
2.	Trial Balance (electronic)				
3.	Access to General Ledger detail				
4.	Crosswalk of accounts to Financial Statement line items				
5.	Statement of intra-departmental elimination entries for FYXXXX				
6.	Management's Discussion and Analysis/Overview				
7.	Draft Financial Statements (electronic)				
8.	Draft Footnotes to F/S (electronic)				
9.	FYXX year-end SF-132s				
10	Detail Schedule of Undelivered Orders (electronic)				
11	Post-closing trial balances (electronic)				
12	Complete Chart of Accounts (if other than SGL)				
13	Schedule of summarized FACTS data				
14	Organizational chart(s) of all agency departments indicating key personnel and their responsibilities.				
15	Minutes of the audit committee for the period under audit.				
16	Annual Performance and Strategic Plans				
17	Any corrective action plans related to prior year DOD IG, GAO, Defense Contract Audit Agency, internal audit, or external audit report, if any				

One tool to help you is the auditor's request for client information, commonly called a PBC list. The PBC list is often provided to the auditee and identifies areas of audit focus such as required access, documentation, interviews, and/or diagrams. It also identifies dates for auditor availability. It can facilitate the audit process by ensuring coordination with those points of contact the audit team will need to meet with.

Remember, it's not just accounting information, since much of the originating documentation may be in non-accounting organizations. For example, PP&E should be tested for existence or completeness at the site long before the auditors arrive. It's important to coordinate the right people and documents at the right place at the right time. If you can't support the numbers before the auditors arrive, it won't happen after.

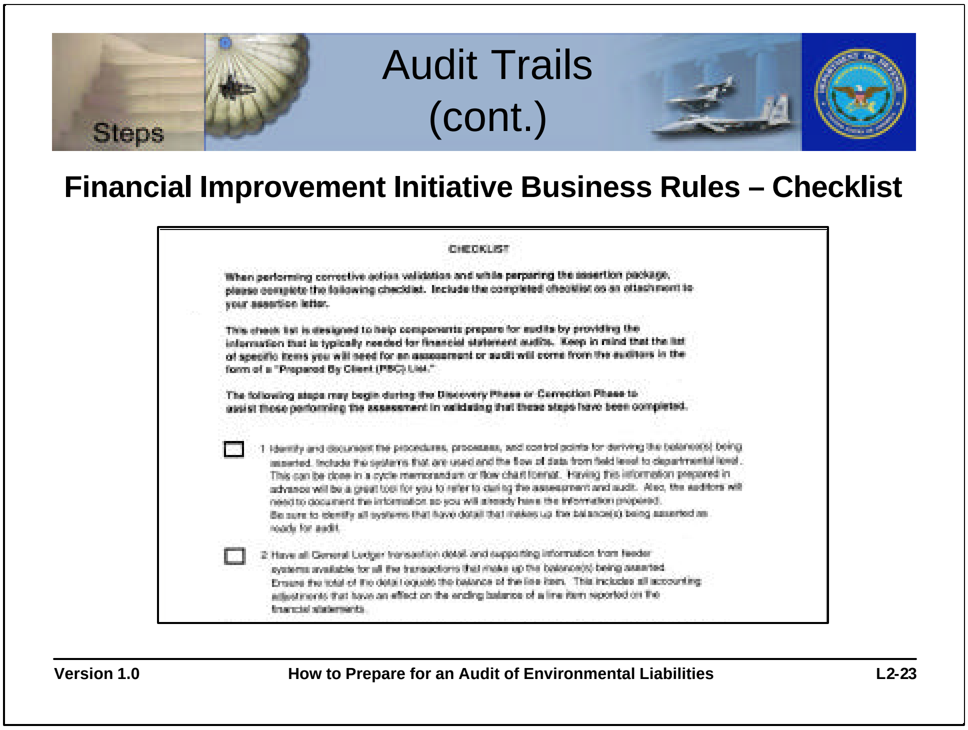
Let's look at an example of an environmental audit trail that we discussed earlier in the course.



Earlier I showed this slide in reviewing the process, but it is also an example of the location of documentation to support the audit trail. Each activity that is tasked to act on an environmental liability may have certain retained documentation that supports the ultimate cost estimate/transaction affecting the balance sheet.

It's important to know where these sources of supporting documents are and who is responsible for them. An auditor will want to review the source documents for an estimate during the process of the financial statement audit.

Now we turn our attention to the Financial Improvement Initiative Business Rules checklist.

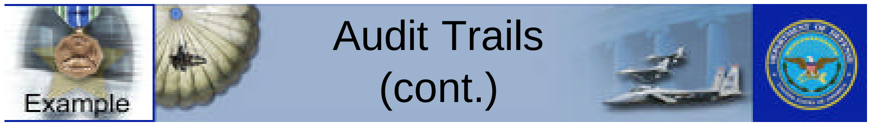


There are 18 steps on the Financial Improvement Initiative Business Rules checklist and is located in Appendix F of this course. The first step discusses a cycle memorandum or flowchart to describe how the financial statement balances are derived. We will look at this a little closer on the next slide, but first, let's look at Step 2.

Getting all the general ledger transaction detail and supporting real property information from feeder systems isn't something you can run out and do the day the auditors are reviewing your environmental liabilities. It requires planning and coordination.

Step 3 goes on to says you should consolidate evidential matter that supports the transactions in Step 2, or map where the documentation is located so that you can find and retrieve it quickly and easily. As an example, DFAS uses a folder process to gather documentation and to be prepared to make it easier for answering the auditors' questions. The method of estimation and all the details are important documentation that support the cost estimate.

The Business Rules and Checklists were developed by the OUSD(C). Now let's look at an sample cycle memorandum.



Excerpt from Navy Cycle Memorandum

Recordation:

Site Establishment –

1. **Facility (site) requiring environmental restoration is identified by Remedial Project Manager (RPM).**
2. **Field activity RPM completes DSERTS form to "Add New Site". The form is electronically sent to NAVFAC HQ for review and approval. *See Tab 3 Attachment 1***
3. **Field Activity records new site information into Facilities Information System (FIS) with pending activity approval code.**
4. **FIS data trickles down into NORM.**
5. **If not an existing site, Remedial Project Manager (RPM) sends request to NAVFAC stating nature of problem and specific information, requesting new site approval.**

In Step 2 of the Business Rules checklist, we saw reference to a cycle memorandum or flowchart to describe how the financial statement balances are derived. The cycle memorandum is used to identify and document each step in the process.

This excerpt, supplied by the Navy, describes some of the steps necessary to record environmental liabilities on the Department of Navy financial statements.

To develop this cycle memo required extensive review of all documents, systems, and people who affect the development of the environmental liability estimate, which is provided as input to the financial statements.

The point is that it isn't a quick turn-around product that can be produced, while the auditor waits. It must be planned for and developed with the intent to be ready for an audit ahead of time.

Information

Audit Trails (cont.)

Copies of supporting documentation must follow the PP&E associated with environmental liabilities when it:

- **Transfers to another activity**
- **Is traded, sold, or disposed of, through salvage or demolition**

NARA GRS: http://www.archives.gov/records_management/records_schedules.htm l

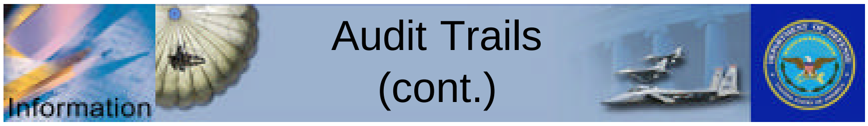
It is important for copies of supporting documentation to accompany the General PP&E and continue to be retained in accordance with Volume 1, Chapter 9, of the DoDFMR and NARA.

When disposed of through salvage or demolition, a copy of the original acquisition documentation and disposal documentation must be retained per the applicable NARA instructions. The General Records Schedule (GRS), found at the NARA GRS web site, provides detailed guidance on record retention for every type of record maintained by the Department. You should be aware of the specific requirements for the documentation that you use.

All supporting documentation should be retained:

- In accordance with the NARA GRS and agency-specific instructions
- As original documents and/or hard or electronic copies in a readily available location.

Next let's look at adjustments and their documentation requirements.



Audit Trails (cont.)

Adjustments to accounting records:

- **Memorandums for Record (MFRs)**
- **Journal Vouchers (JVs)**
- **Other adjusting documents**

Errors are more prone in non-routine transactions, so pay particular attention when making adjustments.

Anytime you need to make adjustments to a transaction, you should remember the consequences of that adjustment by providing adequate support to the adjustment.

What is needed is written documentation that is sufficiently detailed to provide an audit trail to the source that requires the adjustment. This documentation ought to include the rationale and justification for the adjustment, detailed numbers and dollar amounts of errors or conditions that are related to the transaction or record that is proposed for adjustment, the date of the adjustment, and the name and position of the individual approving the adjustment.

It is important to remember that errors are more likely in non-routine transactions, so pay particular attention when making adjustments.

Let’s examine electronic documentation.

Electronic Document Access

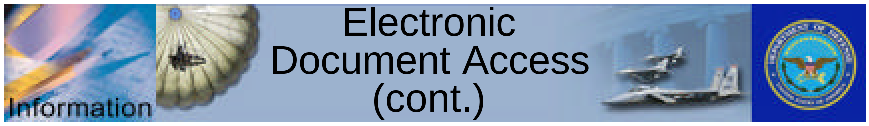
Support documents are found in both paper and electronic format. Documents scanned into an electronic medium or those created electronically may be authorized to act as the official document.

Official electronic documents do not require a paper backup, nor should one be kept, unless specific guidance requires paper copies at specific points in time, like quarterly or year-end.

Once documents are scanned, there is typically no need to retain paper documents.

In addition to the Electronic Document Access (EDA) used by DFAS, there are other systems holding specific documentation or linking documents to other databases.

For example, several installations have fielded a system that ties visual maps and schematics to specific documents, simply by clicking the object on the screen. The user might select an Underground Storage Tank (UST) to retrieve specific documentation available for that feature.



Electronic Document Access (cont.)

Procedures must be in place to provide supporting documentation within two working days.

This means you must know the location and types of documentation that will be reviewed in the audit – including that which is in electronic format.

Once the auditors have reviewed documents supplied in the assertion package (discussed in Lesson 3), and those items listed on the PBC list, they review supporting documentation. The Point of Contact (POC) is now responsible for providing this documentation within two working days. If an entity needs more than two days to provide the requested data, then the Department of Defense Office of the Inspector General (DoD OIG), and reporting entity POCs will coordinate an acceptable turn-around time for providing the documents to the auditors.

To facilitate a two day window, you must have procedures in place to recall supporting documentation and an idea of the types of documentation that will be necessary.

You must be familiar with file retrieval tools and locations of files, both hard copy and electronic, as well as code structures or elements to be used in queries as discriminators for the recall of these detailed documents.

Let's summarize what we learned in this lesson.

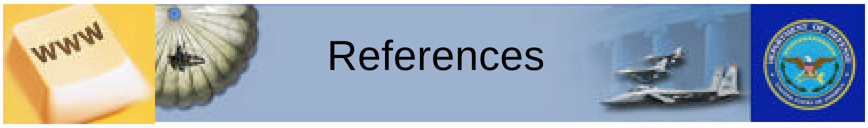
- **Types of Supporting Documentation**
- **Documentation for Engineering Estimates of Liabilities**
- **Audit Trails**
- **Electronic Document Access**

In this lesson, you reviewed various types of documentation then looked more closely at that which supports engineering estimates.

You learned that in order to produce estimates for future payments you needed to know what was probable and reasonably estimable.

Documentation requirements for cost estimates were discussed as well as the DoDFMR requirements for audit trails. You learned that often electronic, or scanned documentation, can replace paper copies negating the need to retain the paper copy.

The following slides list references available for additional information.



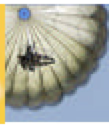
References

DoDFMR: http://www.dod.mil/comptroller/fmr/

DoD OUSD AT&L Recognizing, Measuring, and Reporting Non-DERP Environmental Disposal and Closure Liabilities, May 2005, and Audit, Achieving Auditable Environmental Liabilities

Federal Financial Accounting and Auditing Technical Release No.2: http://www.fasab.gov/aapc/technicl.html

AICPA Standards: http://www.pcaobus.org/standards/Interim_standards/index.aspx

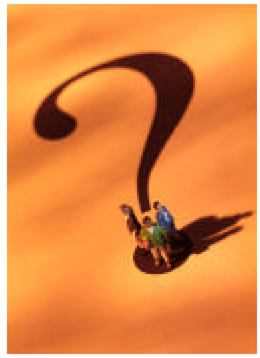


References (cont.)

NARA GRS:
http://www.archives.gov/records-mgmt/ardor/

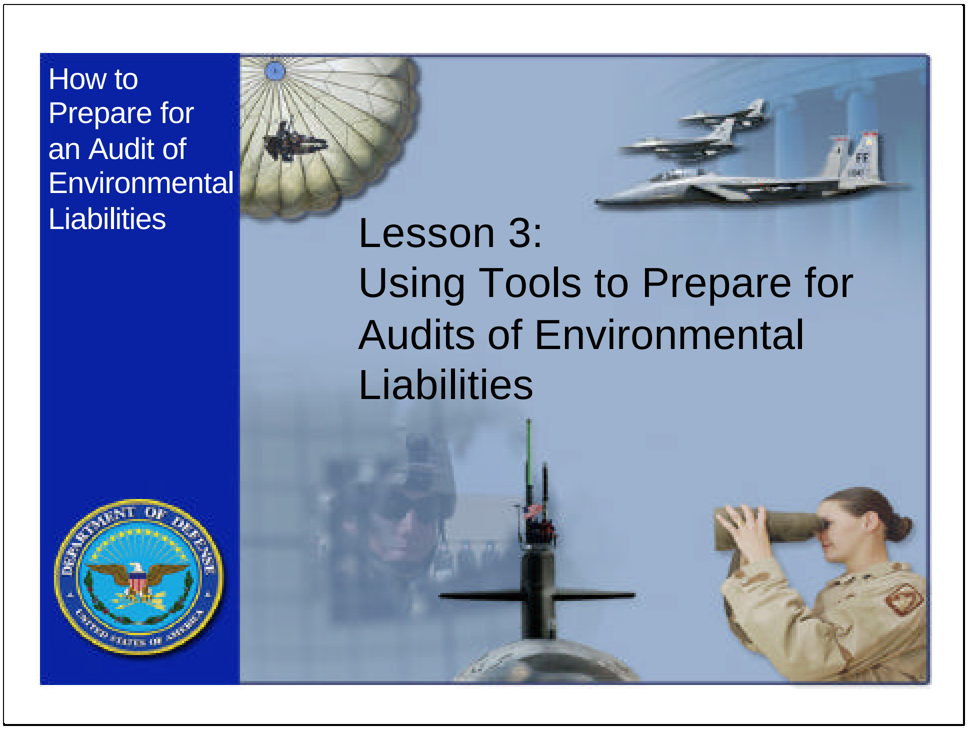
U.S. Treasury Judgment Fund:
http://www.fms.treas.gov/judgefund/index.html

Questions



Version 1.0 How to Prepare for an Audit of Environmental Liabilities L2-32

Before we move on to Lesson 3, Using Tools to Prepare for Audits of Environmental Liabilities, do you have any questions on the material covered in this lesson?



In Lesson 3, we discuss the tools available to prepare for audits of environmental liabilities.

Let's discuss the lesson objectives.

Upon successful completion of this lesson, you will be able to:

- **Explain how to prepare for an audit of environmental liabilities**
- **Describe how to apply the Financial Improvement Initiative Business Rules to environmental liabilities**
- **Identify parameters for audits of environmental liabilities**

This lesson will explain how to prepare for an audit of environmental liabilities by looking at some of the tools at your disposal.

Of particular interest is the Financial Improvement Initiative Business Rules because they are the part of the Department's solution to the problem of unreliable financial statement reporting. Refer to Appendix F in your Student Guide for more information.

The Business Rules describe the oversight process the Department established to ensure that the corrections described in Component plans are implemented and validated. They provide a framework to move the Department toward an unqualified audit opinion.

Let's review the lesson topics.

This lesson contains the following topics:

- **Roles and Responsibilities**
- **Audit Readiness Business Rules**
- **Discovery and Correction Phase**
- **Validation Phase**
- **Assertion Phase**
- **Assessment Phase**
- **Audit Phase**
- **Metrics/Measurements**

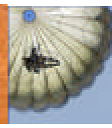
Version 1.0 How to Prepare for an Audit of Environmental Liabilities L3-3

In this lesson, we discuss various roles and responsibilities of those involved in the preparation and execution of financial statement audits. We also step through the five major phases of the Financial Improvement Initiative Business Rules. Each phase has a specific function that requires management's attention.

The Discovery and Correction Phase is when you identify and correct deficiencies and plan how to prevent them from recurring. The Validation Phase validates the corrections made and enhances the credibility of the assertions. The Assertion Phase is when you state that you are ready for an audit. The Assessment Phase attests to the management assertion for the preparation of the audit. If everything is approved, then the audit is scheduled.

We will conclude this lesson with a quick look at some of the metrics and measurements related to environmental liabilities.

Let's begin with roles and responsibilities.



Roles and Responsibilities

Key roles in an audit are assumed by the:

- **Auditor**
- **Audit Liaison**
- **Managers**
- **Defense Finance and Accounting Service (DFAS)**
- **Department of Defense (DoD) Reporting Entities**
- **Various guidance provided at all levels**

Version 1.0 | How to Prepare for an Audit of Environmental Liabilities | L3-4

We will discuss the roles and responsibilities of the auditor, the audit liaison team members, managers, Department of Defense (DoD) reporting entities, and Defense Finance and Accounting Service (DFAS) in relation to what is required at each phase of the audit preparation.

In addition to individual roles and responsibilities, there are some roles and responsibilities that apply to everyone. We must ensure that there is adequate evidential documentation, including both system files and hard copy documentation, as necessary. We must also verify procedures and controls, know the numbers reported in our financial information, and be able to explain abnormalities and normal fluctuation.

Auditors are expecting access to all personnel, facilities, records, reports, databases, documents, or other entity information needed to accomplish an announced audit objective. Remember, the best way to do well is to think like an auditor. Know the process so that you can anticipate the next step. Develop a method of organized folders that contains ready references to each question you know will arise. Make the audit preparation an on-going process and not something that you need to accomplish at the last minute. Coordinate with all the Point of Contacts (POCs) who will be involved, regardless of location or organization.

Let's look more closely at the roles and responsibilities of auditors.

Roles and Responsibilities (cont.)

Auditor

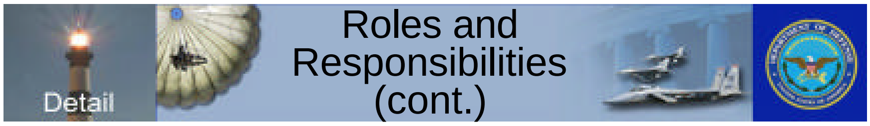
- **DoD Office of the Inspector General (DoD OIG) is the independent auditor of the Department**
- **Independent objective unit**
- **Performs independent reviews of Agency programs and operations**
- **Responsible for financial audits within the Department**
- **Identifies material weaknesses**

The mission of the DoD Office of the Inspector General (DoD OIG) is to be an independent and objective unit within the DoD that conducts and supervises audits and investigations relating to the programs and operations of the Department. The Inspector General Act provides for independent reviews of Agency programs and operations.

The Inspector General (IG) is charged with the responsibility for the audits of the financial statements. As the Department's financial operations are updated and its financial statements become ready for audit, it will be the DoD OIG who will either perform the audits or contract with a Certified Public Accountant (CPA) to perform audits under the supervision of the IG's staff.

The DoD OIG is a key partner in the Financial Improvement Initiative and provides its expertise in a variety of ways. For example, the DoD OIG identified 11 material weaknesses that were reported in the Department's Fiscal Year (FY) 2004 Performance and Accountability Report (PAR). In this way, the DoD OIG assists the Department in determining what needs to be updated. Additionally, the DoD OIG staff participates, as non-voting members, on the audit committees established by each of the Components that prepare audited financial statements. The DoD OIG holds advisory membership on the Executive Steering Committee (ESC), the Review and Prioritization Subcommittee (RPS), and the Funding Subcommittee, which make up the governing structure for the Financial Improvement Initiative.

Let's discuss a few more of the duties of the DoD OIG auditors.



Roles and Responsibilities (cont.)

The auditors' responsibilities include:

- **Understanding the entity's internal control**
- **Providing the Prepared By Client (PBC) list**
- **Examining evidential matter**
- **Auditing or assessing**
- **Communicating issues and progress**
- **Expressing an opinion on the financial statements**

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After an entity is selected for audit, the auditors acquire an understanding of the organization's internal control by reviewing the reporting entity's assertion package during the Assessment Phase. The Assessment Phase is the internal control portion of an audit. The remainder of the audit is completed only if internal controls are determined, during the Assessment Phase, to be adequate.

Auditors provide a list of items required prior to the audit. This list is called the Prepared by Client (PBC) list. The list is examined to ensure that supporting evidence supports the amounts and disclosures on the financial statements.

If the results of the assessment indicate that an area is not ready for audit, the auditors identify those deficiencies and provide recommendations to the Department. When results indicate the entity is ready for audit, the auditors establish audit procedures.

The DoD OIG or the Independent Public Accountant (IPA) performs the audit in a professional and effective manner. During the audit process, the auditors communicate progress, address issues, and finally express an audit opinion on the financial statements.

Next, we identify other audit organizations that are able to perform an audit of your entity.

Detail

Roles and Responsibilities (cont.)

Other audit organizations:

- **Service auditors**
- **Agency internal auditors**
- **Defense Contract Audit Agency (DCAA)**
- **Government Accountability Office (GAO)**

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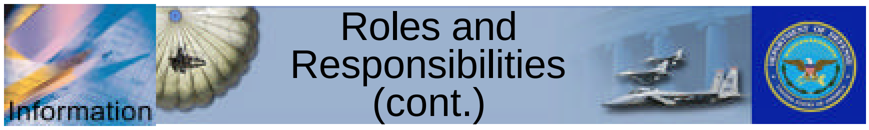
Although we discussed that the DoD OIG is responsible for financial statement audits, other audit organizations have specific roles and responsibilities too. For example, the Naval Audit Service may assist with the Navy's effort to achieve an unqualified audit opinion by assisting in the discovery and correction of deficiencies. They may also assist in the validation of management's corrective actions, but assessment and audit of an entity are the purview of the DoD OIG.

Other audit organizations, such as the Defense Contract Audit Agency (DCAA) or the Government Accountability Office (GAO), may audit for specific reasons that relate to input to the financial statements, but again, the annual financial statement audit is the responsibility of the DoD OIG.

We discussed the role of the auditor, now let's look at the audit liaison.



Roles and Responsibilities (cont.)

Audit Liaison/POC

- **Entity representatives with knowledge of information or evidential matter needed by auditors**
- **Managers, technicians, and staff**
- **Ability to explain departures from normal procedures**

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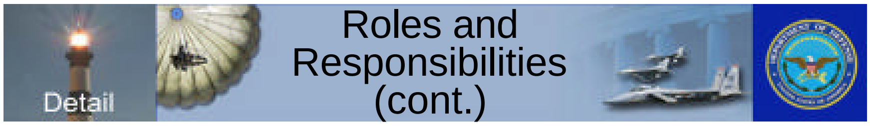
A well-prepared organization is represented by a team of individuals that are responsible for the overall presentation of information to the auditors and works as the liaison with auditors. Team members should be chosen for their knowledge of entity operations, procedures, and financial position. They must be able to respond to questions concerning financial data and entity operations.

The team may be composed of entity managers, technicians, and supporting personnel, in-house or contracted. Audits are lengthy and ongoing processes. Representatives must be available to work with auditors for extended periods. Ensuring that staff is available while still accomplishing the normal operations is a challenge that management must meet. Staff assigned to the financial statements should collectively possess adequate knowledge of the organization, functions, systems, and mission.

Selected members should know what normal balances, transactions, and procedures are and be able to explain any abnormalities. Any departures from normal procedures must be accompanied by evidence of proper justification and approval. Individuals within an organization should understand their importance to this process and how each can contribute to the success (or failure) of the organization.

Let's examine the duties of the audit liaison team members.



Roles and Responsibilities (cont.)

Audit liaison/POC responsibilities:

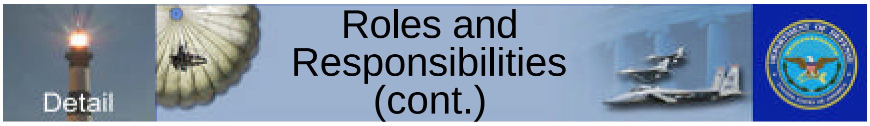
- **Audit record-keeping**
  - **Open requests**
  - **Documents supplied**
  - **Corrections made**
  - **Deficiencies noted, awaiting correction**
- **Information gathering**
  - **Data queries and document searches**
  - **Standard queries prepared in advance**

The audited entity should assign a POC to work with the auditors. Among the POC's duties are the audit record keeping, information gathering, explanation of internal control activities and procedures, and to act as liaison between the audit staff and entity personnel.

Audit record keeping includes maintaining a record of requests for information from the auditor, and the appropriate records of the fulfillment of these requests. Requests come in many forms, but the most common is the PBC list. This list is a record of requested information and documentation, date needed, date supplied, and the entity POC for additional detail. Once the audit begins, information must be gathered to provide the requested records for review by the auditor. Gathering information may include data queries and document searches.

You may establish processes prior to the audit to facilitate speedy data access. Standard queries run on sample data may ensure that processes and queries provide the required information, while tests may ensure that procedural problems that allow for errors in documentation are discovered prior to the audit. Proper sample information must be able to be traced from the transaction level to the financial statements.

Let's review more audit liaison duties.



Roles and Responsibilities (cont.)

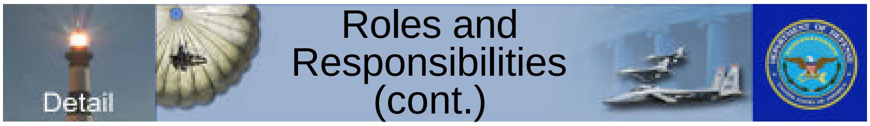
Audit liaison/POC responsibilities (cont.):

- **Explanation of internal control**
  - **Financial reporting controls**
  - **Compliance controls**
  - **Operations controls**
  - **System controls**

Explaining internal control begins with the identification of controls and systems. These include financial reporting controls that lead to the financial statements, compliance controls, and certain operations controls. Information system controls include general controls, application controls, and user controls.

The audited entity must set the tone for the audit at the first contact with the auditor.

Let’s take a look at some of the activities of the audit liaison/POC.



Roles and Responsibilities (cont.)

Audit liaison/POC activities:

- **Communicate the scope**
- **Identify required information**
- **Identify required resources**
  - **Telephones**
  - **Fax machines**
  - **Copiers**
  - **Computers**
  - **Office space**
- **Organize meetings**

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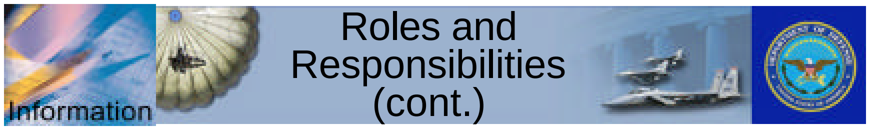
Audit liaison activities include communicating the scope of the audit and information and resources required. This includes identifying equipment such as telephones, fax machines, computers, and office space. Liaison activities also include the organization of meetings with the auditor.

Now let's consider the role of the individual managers.



Roles and Responsibilities (cont.)

Managers

- **OMB Circular A-123 and Appendix A, Internal Control over Financial Reporting, outlines managers' responsibilities**
- **Take systematic and proactive measures**
- **Report annually on controls**
- **Audits are assessments of how well an entity controls its resources**

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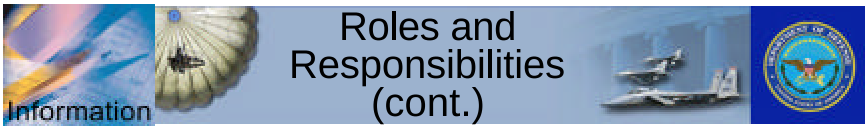
According to the Office of Management and Budget (OMB) Circular A-123, Management's Responsibility for Internal Control, and Appendix A, Internal Control over Financial Reporting, managers are responsible for the quality and timeliness of program performance, increasing productivity, controlling costs and mitigating adverse aspects of Agency operations, and assuring that programs are managed with integrity and in compliance with applicable law.

Managers must take systematic and proactive measures to develop and implement appropriate, cost-effective management controls, assess the adequacy of management controls in their programs and operations, identify needed improvements, take corresponding corrective action, and report annually on those controls.

Audits are assessments of how well an entity controls its resources. Agency managers are required to follow up on audit recommendations and correct problems resulting from inadequate, excessive, or poorly designed controls, and to build appropriate controls into new programs. In designing appropriate controls, managers must communicate their DoD and systems issues to their Office of the Under Secretary of Defense, Comptroller (OUSD(C)) POC.

Let's discuss these duties in more detail.



Roles and Responsibilities (cont.)

Managers (cont.)

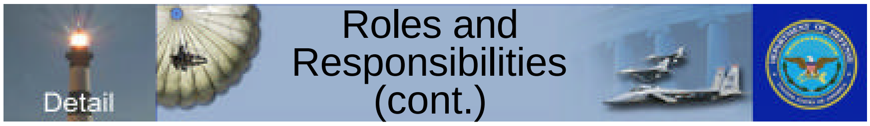
- **Audit engagement letter**
- **Testing, reconciling, and analyzing financial data**
- **Assuring reliability of information in reports**
- **Financial statements**
- **Management representation letter**

The financial statements and accompanying footnotes are also the responsibility of management. This reporting package contains management's discussion and analysis of the financial information presented. The Management Discussion and Analysis (MDA) section is an executive summary of the results of operations, accomplishments, use of resources, and any unusual circumstances.

An audit tests the reliability of the information provided by management in the form of financial statements, reports on management controls, or other assurances or representations. One of the procedures used by management in the accomplishment of their duties involves testing, reconciling, and analyzing specific financial data to validate the information presented for audit.

An engagement letter is prepared to form an agreement with the auditor, and the audit is conducted on the areas represented. Management then prepares a representation letter that attests to management's responsibility for the information provided for audit.

Let's look at a few of the procedures that are used by management in validating this information.



Roles and Responsibilities (cont.)

Procedures used by managers:

- **Calculate variances**
- **Compare current to prior periods**
- **Compare related data**
- **Analyze account balances and age**
- **Any unusual balances or significant entries must be explained**

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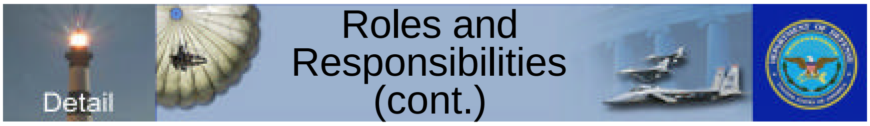
Financial data is analyzed in a variety of ways; one of the more common methods of analysis is to calculate absolute variance of line items. When dealing with cost variance, always use the absolute variance. The absolute variance is considered the absolute value of all variances. For example, if two line items are counted and the first one has an extra $100 part and the second line item is short a $100 part, the cost variances zero out and will be viewed as a zero variance. However, the absolute variance is $200, the true value of the errors.

Managers must understand the reasons for variances and be able to present this information to users of the financial data. The inability to explain variances may lead auditors to think about control weaknesses, fraud, and inherent risks. Some of these steps are also completed as part of the audit process.

Reconciliation of financial statements involves comparing current period data to prior period data, and related balances from one financial statement to another in the same period such as the Statement of Budgetary Resources to the Statement of Net Cost. Any differences between expected balances and actual data must be explained during the audit. Managers should analyze general ledger accounts and balances. Any unusual balances or significant entries must also be explained. Explanations must be made in a meaningful, non-technical manner.

This analysis gives you a better understanding of the financial position of your entity and how significant management decisions affect that financial position.

Now let's look at documenting the flow of data.



Roles and Responsibilities (cont.)

Additional procedures used by managers:

- **Document data flow**
- **Ensure availability, completeness, accuracy, and validity of supporting documentation**
- **Identify and test controls and systems**
- **Staff adequately**

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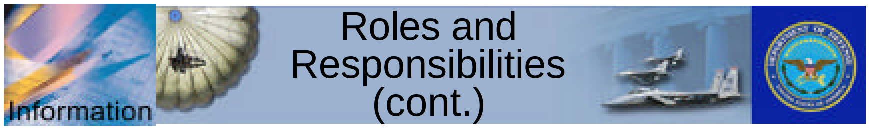
Documenting the flow of data is a process by which transaction data is traced from initiation, through the financial and non-financial feeder systems, to the eventual reported financial information. Some data that supports a financial transaction is not strictly financial data such as time and attendance records, inventories, transportation bills of lading, or property deeds. Documenting the flow of data is a critical step in preparing for an auditable universe. An auditable universe exists when supporting documentation is available, complete, accurate, and valid for all audited transactions.

Once the flow of data is documented, testing of controls and systems for the reporting of that data begins. Tests of controls and systems are designed to ensure that transactions are properly authorized, that resources are protected, and that systems support appropriate controls.

Management must ensure that sufficient knowledgeable staff is available, not only to support the audit, but to support ongoing financial management efforts. Financial management occurs throughout the year, not just at year end. Managers must communicate audit requirements to members at all levels of the organization.

Let’s now talk about the role of the DoD reporting entities.



DoD Reporting Entities

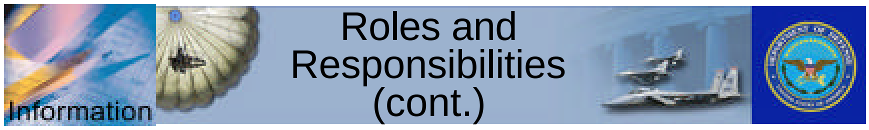
- **Agency-wide statements are required to cover all accounts and associated activities of each office, bureau, and activity of the Department**
- **Military Departments and Defense Agencies are working diligently to correct the deficiencies that are keeping them from asserting that they are ready to have their financial statements audited**

The OMB requires the DoD to prepare Agency-wide audited financial statements in accordance with the Chief Financial Officers (CFO) Act and the Government Management Reform Act (GMRA). The Agency-wide statements are required to cover all accounts and associated activities of each office, bureau, and activity of the Department.

Financial improvement plans designed to ensure that the Department achieves an unqualified audit opinion have been prepared by the Military Departments, Defense Agencies, and other primary fund-holders.

As the largest fund-holders in the Department, the Military Departments (Department of Army, Department of the Navy, and Department of the Air Force) are key elements in the Financial Improvement Initiative. Additionally, they hold the greatest share of the assets reported on the Department's Agency-wide Balance Sheet. Most of the process and control changes necessary to the initiative must be implemented within the Military Departments and the Defense Agencies. These Departments and Agencies are working diligently to correct the deficiencies that are keeping them from asserting that they are ready to have their financial statements audited.

One agency that is particularly important to the auditing effort is DFAS. Let's examine the role of this agency.



Roles and Responsibilities (cont.)

DFAS

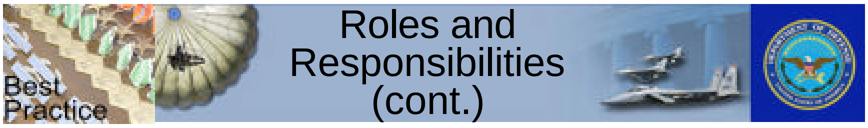
DFAS provides finance and accounting services for the DoD. DFAS initiatives are focused on fixing business processes that are within its control, such as:

- **Fund Balance with Treasury (FBWT)**
- **Accounts Receivable and Accounts Payable**
- **DFAS systems (DFAS is not responsible for feeder systems not under their control)**

The mission of DFAS is to provide responsive, professional finance and accounting services for the people who defend America. In providing these services, one of the goals of DFAS is to fully satisfy customer requirements and aggressively resolve problems to deliver best-value services. In doing this, DFAS must continually review current finance and accounting systems and procedures, and identify improvements that can be made to processes and systems. DFAS initiatives are focused on fixing business processes that are within its control, such as Fund Balance with Treasury (FBWT), accounts receivable and accounts payable, and DFAS systems. DFAS is not responsible for feeder systems not under their control.

DFAS has already held DoD-wide conferences on DFAS business processes and systems audits with their customers, the DoD audit community, and the Government Accountability Office (GAO).

Let’s look at a few useful practices that you may implement in preparing for an audit of your entity.



Roles and Responsibilities (cont.)

Best Practices

- **Plan meetings**
- **Implement schedules and hold regular progress meetings**
- **Discuss new standards and policy**
- **Discuss findings and audit adjustments**
- **Review interim financial statements**
- **Review lessons learned**

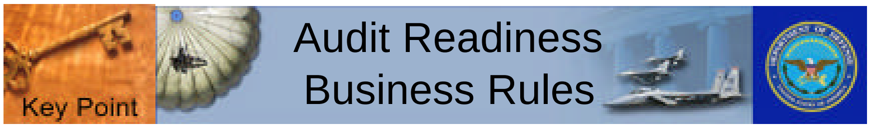
Here are a few practices that you may find useful. Meetings should be planned with a clear agenda that lists topics to be discussed. Any read-ahead material should be distributed well in advance of the meeting to ensure that participants have ample time to plan their own comments. It should start and end on time, but should allow time for discussion.

Schedules should be implemented that build into the reporting entity's financial improvement plans the plans for their suballotees (subordinate organizations). Regular progress meetings should be held to establish communication lines between the reporting entity, their suballotees, and their OUSD(C) POC. Regular communication should discuss new standards and policy to ensure the widest dissemination throughout the entity. Those most affected by changes to standards or policy may require specific training.

In discussions of findings and audit adjustments, entity management should identify action teams to plan and implement solutions. Reviews of interim financial statements may point out trends or unusual activity that can be corrected immediately, or that may require action or explanation at a later date.

Many organizations publish lessons learned from previous inspections, reviews, and audits. Review of these lessons both within and outside your organization may prevent you from making similar errors. They may also point out deficiencies within your organization that had not been identified previously.

Let's take a closer look at Department's Business Rules.



Financial Improvement Initiative Business Rules provide information on:

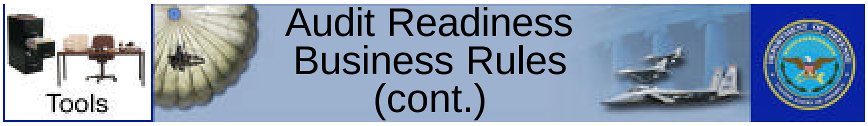
- **Five phases to pass an audit**
- **Complying with the five phases of the business rules**
- **Implementing Section 1008 of the National Defense Authorization Act for Fiscal Year (FY) 2002**
- **Preparing a Management Assertion Letter**
- **Completing a checklist when performing corrective action validation and while preparing the assertion package**

Section 1008 of the National Defense Authorization Act for FY 2002 required that the Under Secretary of Defense, Comptroller (USD(C)) assess the reliability of the DoD financial statements. For those statements deemed unreliable, the USD(C) redirected resources expended on financial statement preparation toward improving the entity's ability to report reliable financial information.

The Department is accomplishing the difficult task of improving financial management through a key tool explained in a memorandum titled Financial Improvement Initiative Business Rules, dated June 23, 2004 (in Appendix F of Student Guide). It explains the business rules DoD entities need to follow to progress toward an unqualified opinion. This memorandum includes a graphic depicting the path from a disclaimer to a clean audit opinion. The list of business rules is provided to Components and Defense Agencies to assist in determining when financial statement line items are ready for assertion and in preparing their assertion package.

The Financial Improvement Initiative is a five-phase process, Discovery and Correction, Validation, Assertion, Assessment, and Audit. Each phase has a specific function that requires management's attention and is designed to prepare entities to pass a financial audit while improving their ability to control and report on their financial activities.

Let's examine those phases now.



Major Phases

Discovery and Correction	Validation	Assertion	Assessment	Audit
WHY • Discover problems • Evaluate solutions • Plan solutions • Correct processes • Complete policy • Complement BMMP HOW • Develop improvement plans • Establish audit committees • Develop systems strategy • Prepare business cases for systems changes • Prepare and review full set of financial statements each quarter	WHY • Enhance credibility of assertions HOW • At beginning, coordinate and obtain comment from DoDIG and notify RPS • Management documents processes, identifies controls & systems, and ensures auditable universe of transactions & supporting documentation is available • Management requests validation of financial information • Performed by internal review, component's audit agencies, or external audit firm	WHY • Communicate to DoDIG and auditors reliability of financial information HOW • Assertion letter to DoDIG that: 1. Responds to DoDIG's instructions 2. Includes checklist 3. Includes results of validation and reports • Engagement letter and management representative letter, if used • Memo to DoDIG, copy to OUSD (C) RPS • ESC approval for assessment/audit	WHY • Allows remediation • Attests to management assertion • Plan audit • Reduce risk of unknowns (auditor) • Introduction to organization (auditors) HOW • DoDIG oversight of IPAs • DoDIG in-house	WHY • Implement CFO Act • Implement 1008 • Presidents' Management Agenda HOW • Pass assessment • DoDIG oversight of IPAs

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The Discovery and Correction Phase is intended to allow you to correct deficiencies and plan how to prevent them from recurring. This phase might include establishing audit committees like the DFAS audit committee, and developing business cases for systems changes. You might prepare and review a full set of financial statements quarterly to facilitate the annual requirement.

The Validation Phase can validate the corrections made and enhance the credibility of the assertions. Management makes this request, which can be accomplished by internal or external auditors, following initial comment from the DoD OIG. Management also documents the processes, identifies applicable controls and systems, and ensures an auditable universe of transactions and the availability of supporting documentation.

The Assertion Phase lets the DoD OIG know you are ready for an audit, that is, that management has designated staff to work with the auditors and that documentation has been reviewed and is available to support the audit. This is accomplished by submission of the Assertion Package to the DoD OIG based on DoD OIG/OUSD(C) instructions. The package will also contain results of the Validation Phase among other documentation.

The Assessment Phase attests to the management assertion and prepares for an audit. If everything is approved, then the audit is scheduled. The Audit Phase is required by the President's Management Agenda and the GMRA. The audit provides good information on assets and liabilities, cost visibility, and internal controls.

Let's look at the first phase, Discovery and Correction.

Discovery and Correction Phase

Management identifies deficiencies and implements corrective actions

Why	How
Implement 1008, discover problems, evaluate solutions, correct processes, complete policy, complement BMMP	Develop improvement plans, establish audit committees, develop systems strategy, prepare business cases for systems changes, prepare and review financial statements each quarter

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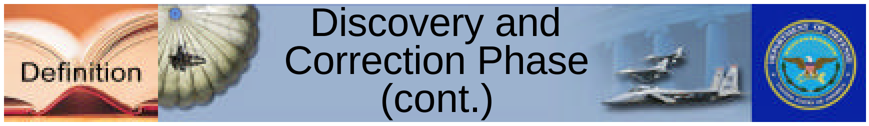
Section 1008 of the National Defense Authorization Act for FY 2002 has allowed the Department to assert that it was not able to provide adequate evidence supporting material amounts in the financial statements. 1008 allows the Department to redirect resources from audits of activities that are known to be deficient to the correction of those deficiencies.

The Discovery and Correction Phase is intended to correct these deficiencies and plan solutions to produce accurate data. Problems may be identified from prior assessments or audits, analysis, tests of controls, or internal reviews of operations and procedures. They may include DoD issues and systems, issues affecting your subordinate organizations (your suballotees), or issues that are internal to your operation. Once problems are identified, you develop plans for corrective action.

These plans must include responsibilities, milestones, and required resources. They should take into account the plans of your subordinate organizations and may depend on the plans of higher organizations. You must monitor progress both within and outside of your organization to ensure that milestones are reached. Resources outside of your organization may be available to you, and solutions found by other organizations may be applicable to problems within your operation. Plans for corrective action may already be initiated on deficiencies found on previous audits and assessments, and new problems may be identified during their correction.

Let's break this phase down into the two components, discovery and correction.



Discovery and Correction Phase (cont.)

Discovery

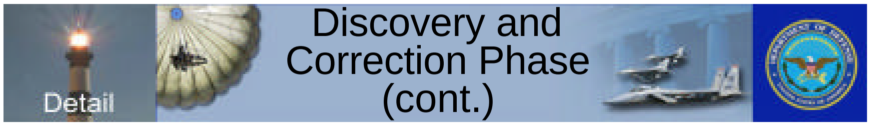
- **Identify all known deficiencies**
- **Identify material weaknesses**
- **Identify obstacles and prepare corrective action plans in pursuit of an unqualified audit opinion**
- **Prepare the financial improvement plans**
- **Implement corrective action**
- **Incorporate effective oversight**

Managers and staff should be encouraged to identify and report deficiencies, as this reflects positively on the Agency's commitment to recognizing and addressing problems. Entities also identify, by financial statements line item, all known deficiencies relating to the line item, including accounts requiring correction or processes requiring improvement. Failing to report a known deficiency would reflect adversely on the Agency. Agencies should carefully consider whether systemic problems exist that adversely affect internal control across Departmental or program lines.

During Discovery, you identify obstacles that could prevent the entity from obtaining an unqualified audit opinion and to prepare improvement plans with solutions that have measurable outcomes for overcoming those obstacles.

The entities then prepare financial improvement plans for achieving an unqualified audit opinion. To prioritize corrective actions, managers should identify deficiencies that have a material impact on the financial statements. Plans must identify how staff (human capital), processes, or business systems would be changed to implement corrective actions. Implemented plans must then incorporate effective oversight mechanisms to ensure that they are carried out and that the corrections are sustainable. Additionally, managers must base milestones on actual estimates of the effort required, and identify critical task dependencies.

Let's explore some areas where problems are found.



Sources Used to Identify Weaknesses

- **Audit/inspection reports**
- **Lessons learned**
- **Policy, procedure, and process reviews**
- **Hot-line reports**
- **Actual analysis**

Problems are identified in audit and inspection reports, from lessons learned in similar organizations, or from reviews of policies, procedures, and processes. They are also discovered through analysis of financial information, documentation, and systems. The establishment of a hot-line to report deficiencies such as those used to capture fraud, waste, and abuse information, without fear of reprisal, may also be a source for an investigation of possible material weaknesses.

Similar entities may experience problems in areas that were not found on previous inspections or audits of your entity. Reviewing the findings of other entities may provide areas of needed improvement in your entity.

Management reviews policies, procedures, and processes to ensure that they are compliant with legal and regulatory guidance, and that they ensure adequate controls over entity resources. New procedures may be required in the absence of pre-existing procedural guidance, especially in areas of high personnel turnover, complicated processes, or high-value asset use.

Let's continue with these sources.

Detail

Discovery and Correction Phase (cont.)

Analysis Steps

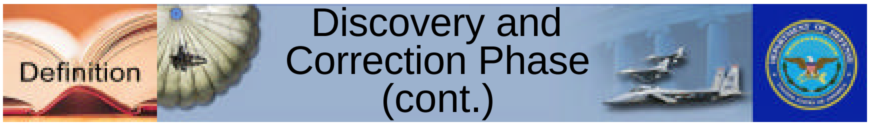
- **Analyze transactions and balances**
- **Trace transaction from origin to consolidation in financial statements**
- **Use available resources to perform systems analysis**

Analysis of financial information, documentation, and systems may be used to identify unusual balances or entries, document trails and areas of inadequate documentation, and system controls. Unusual balances or entries may be the result of failure of a policy, procedure, or control, or of fraud.

Instances when complete documentation doesn't exist to be able to trace transactions from their origin to their consolidation into the financial statements, must be identified. An analysis of the documentation required for transaction types assists in making this identification. Reversing the process traces a consolidated transaction to its origins. Auditors must be able to trace your transactions all the way to the originating documents. They must also be able to verify from those documents that amounts recorded on the financial statements are based on factual information, that adjustments made to that information are made using appropriate accounting practices, and that proper authorization exists at each level of the transaction.

Systems analysis may be accomplished using resources from outside of your entity. The Defense Information Systems Agency (DISA) is one source and another is DFAS. Systems are analyzed to ensure that they are compatible with the future plans of the Department, and that they apply adequate controls for transaction authorization and separation of duties. They are also analyzed for their ability to provide meaningful financial information in a timely manner.

This leads to the second half of the Discovery and Correction Phase, correction.



Discovery and Correction Phase (cont.)

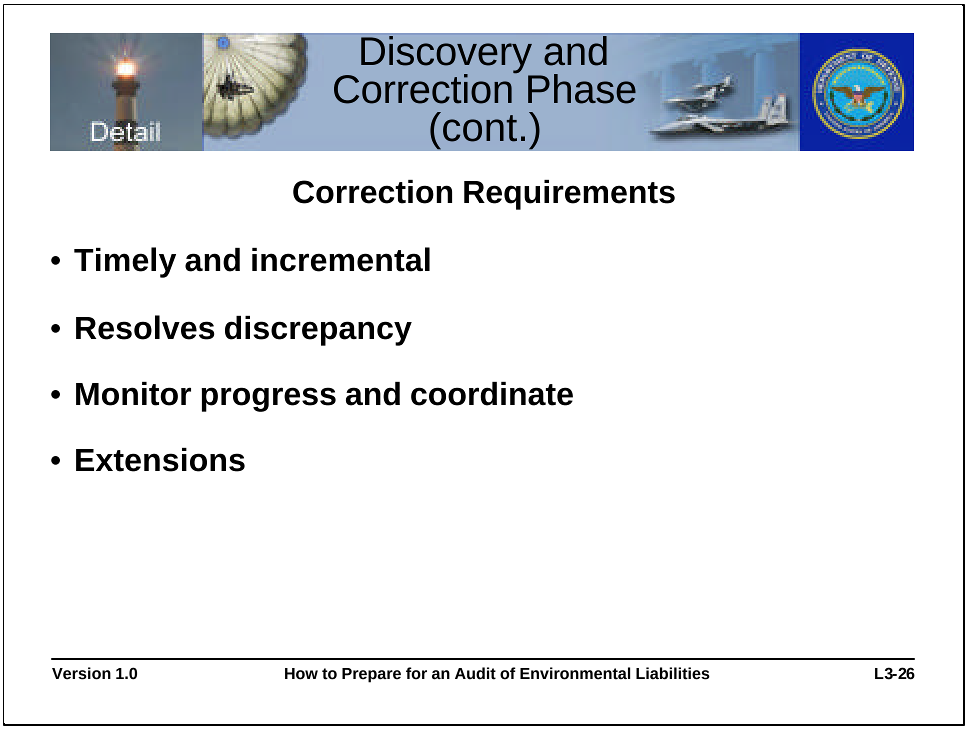
Correction

- **Requires DoD entities to implement solutions within the milestone dates, resulting in a resolution of the identified deficiency**
- **Identify new deficiencies**
- **Modify plans to include any additions**
- **Requests for extension of dates should include a plan for getting back on track to meet the next original milestone date**

Correction requires DoD entities to implement solutions within the milestone dates, resulting in a resolution of the identified deficiency. Correction is a multi-faceted and incremental process. In other words, all corrective action steps are not expected to be completed on the same date. Management personnel and audit committees at each activity closely monitor progress to ensure that actions taken achieve the intended result in the time allotted.

As corrections are ongoing, it is anticipated that new deficiencies may be identified. As this occurs, activities coordinate with their OUSD(C) POC to modify plans to include any such additions. OUSD(C)'s concern is at the key milestone level. Components are required to report whether they are on target to meet Key Milestone Plans (KMPs). If not, corrective actions should be reported.

Let's consider these requirements.

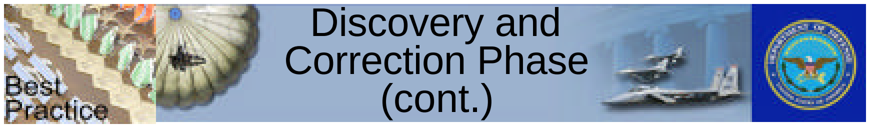


Correction plans must contain milestones and goals that are clearly measurable. Plans are incremental to allow for actions that may involve more than one entity. Management must assign tasks to responsible individuals in accordance with the corrective action plans and monitor progress. Individuals are held accountable for the accomplishment of their assigned tasks.

As with many projects, problems may be encountered that require additional resources or time. Management may reassign resources or request assistance from outside sources. Identified problems may require action from other entities prior to correction of the original discrepancy. In such cases, managers may re-organize actions that are not dependent upon the delayed processes to allow for the continuation of corrections.

When other entities depend on the resolution of your deficiency, it is important to coordinate with the dependent entity. Together, you should work to identify resource requirements, coordinate schedules, and modify interim milestones. As mentioned earlier, you must have a plan for meeting the next original milestone.

Let’s examine some best practices.



Discovery and Correction Phase (cont.)

Best Practices

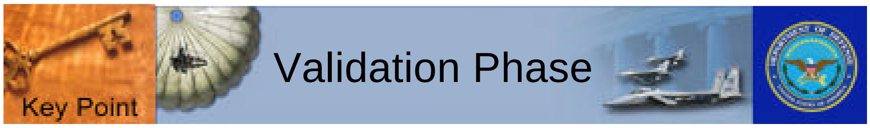
- **Hold regular progress reviews**
- **Know your deficiencies**
- **Document responsibilities**
- **Facilitate functional and financial**
- **Use available assistance**

Suggested practices that have served well in similar organizations concerning discovery and correction are to have reviews regularly so you know how you are doing. As part of the monitoring process, reviews allow managers to identify resource requirements that may not have been anticipated in the corrective action plans. Reviews should have clear agendas and require responses from participants as to the status of their progress.

You must document responsibilities and ensure that you have clearly communicated who must perform the action, what must be done, when it must be completed, and the expected result of that action. Successful organizations do not attempt to solve problems outside of their areas of expertise. DFAS is an invaluable source of assistance. Its employees are familiar with audit requirements and have in fact passed more than one financial statement audit. They are knowledgeable of the financial reporting requirements, documentation requirements, financial systems and their capabilities, and financial management trends. They may provide assistance in analysis of financial transactions and balances, and may be able to explain unusual transactions that affect your financial statements.

Audit agencies may provide assistance with analysis and historical audit records. Other agencies like DISA provide specialized assistance in their areas of expertise.

Let's continue with the Validation Phase.



Validation Phase

Management obtains validation of financial information after corrective actions are remedied

Why	How
Implement 1008, enhance credibility of assertions, validate that corrections are remedied in the Validation Phase.	First, management coordinates with DoD OIG and notifies the Review and Prioritization Subcommittee (RPS). Second, management validates that processes are documented, controls and systems are identified, and supporting documentation is available.

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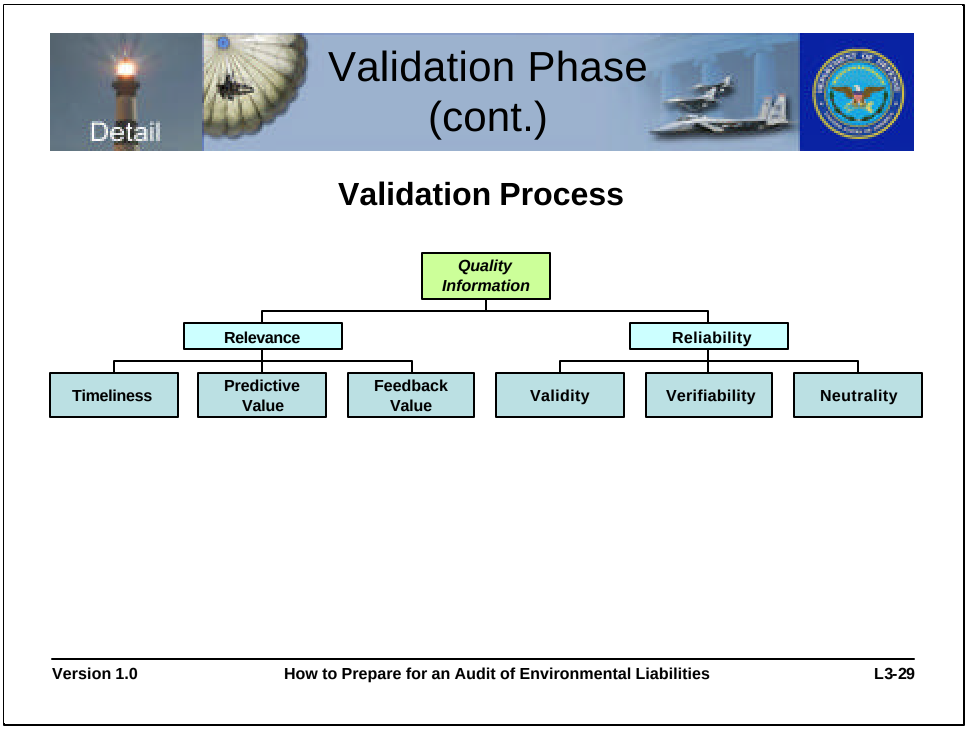
The Validation Phase evaluates the effectiveness of the corrective actions. Validation determines whether sufficient controls and transaction information are available to support management's assertion that the line or financial statements are ready for audit, and ensures that supporting documentation is available during the audit.

The validation is a limited scope evaluation or review to determine whether previously identified deficiencies in an entity's financial statements or line items have been satisfactorily corrected. This review is the responsibility of management and performed by management, internal auditors, or an IPA. The scope of specific procedures required for each validation are also the responsibility of management and are determined in the context of the materiality of each issue or action taken.

Let's continue with more of the Validation Phase.



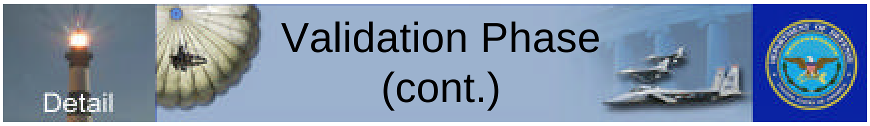
At the beginning of the Validation Phase, the entity notifies the DoD OIG by memorandum, with a copy furnished to the entity's OUSD(C) POC, of the entity's intent to validate a line item or statement and the corrective actions taken to resolve deficiencies. It is important to tell the DoD OIG what you plan to do. The DoD OIG must be aware of the validation technique being performed by the entity prior to the initiation of the validation process to facilitate the assessment process after the entity submits its assertion package. Although the DoD OIG has no specific role in the validation, the DoD OIG may, in an advisory capacity, comment on any obvious flaws or items of concern related to the validation methodology.

The OUSD(C) POC then notifies the RPS. The RPS notifies the ESC, and, if any concerns exist, the ESC provides a memorandum to the entity conveying its concerns.

The notification includes the intended method for validating that the corrective action corrected the known deficiency, and that the line or statement is ready for audit. Once required notification is sent, and validation methods are planned, the validation process begins.

The validation process is primarily for management to determine whether a particular statement or line is ready for an assessment or audit by the DoD OIG. To be audit-ready, information provided in the statement or line must be both relevant and reliable. Relevance is related to the usefulness of the information, such as its timeliness, predictive value, or feedback value. Reliability relates to the accuracy of the information. To be reliable, the information must be valid, verifiable, and unbiased or neutral. If management determines that the statement or line is ready, the work accomplished during validation may be used by the DoD OIG.

Let's discuss the actions required in this phase.



Validation Phase (cont.)

Assertion Package Organization and Review Criteria

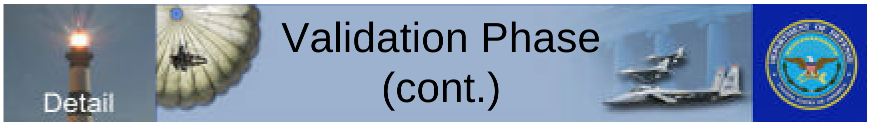
TAB	TOPIC	Checklist Step
1	Process Cycle Memos and Flow Charts	1
2	GL Transaction Detail/Support	2
3	Evidential Matter	3
4	Validation Summary (Management Assertion Letter, Completed Assertion Checklist, and Validation Work Products such as completed GAO Checklists, etc)	4
5	Status of FIP Corrective Actions	5
6	Summary of Corrective Actions Taken	6
7	Organization Charts/Contact Lists	7
8	FISCAM and SAS 70/88 Audit Date and POCs	8
9	FISCAM and SAS 70/88 Audit Results	9
10	Hardware, Software, and Interfaces	10
11	Type of Data Produced	11
12	Telecom/Network Information	12
13	Certifications/Accreditations	13
14	System/End User Locations	14
15	Location of Systems Documentation	15
16	Data Type/Summary of Transactions (Number, Type, Dollar Value)	16
17	List of Authorized Users	17
18	List of On-Going or Planned Reviews	18

During the Validation Phase, the entity performs a validation of the resolution of the identified deficiencies. These validations are performed at the request and under the oversight of management. Audit committees within the entity should be actively engaged in overseeing the progress of the validation process.

At this time management completes a checklist that is required for the assertion package. The checklist includes such steps as documenting processes, identifying controls and systems, and ensuring that supporting documentation is available. This checklist and accompanying assertion information is used later during the Assessment and Audit Phases.

Notice that the checklist begins with the topic Process Cycle Memos and Flow Charts. To use the checklist, you must read the accompanying instructions that provide a full description of what is required to fulfill the checklist item.

Let's examine the first item to demonstrate the use of this validation tool.



Requirements for Checklist Item 1: Process Cycle Memos and Flow Charts

- **Identify and document the procedures, processes, and control points for deriving the balances**
- **Include the systems that are used and the flow of data from field level/installation to departmental level**
- **Identify all systems that have detail that make up the balances**

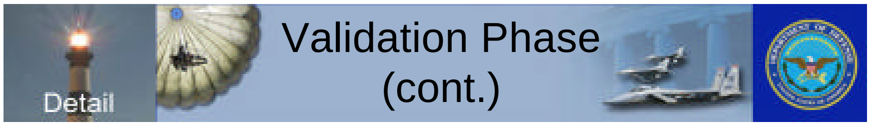
In Processing Cycle Memos and Flow Charts, the user needs to identify and document the procedures, processes, and control points for deriving the balance or balances being asserted. The user needs to include the systems that are used and the flow of data from field level or installation to departmental level.

This can be done in a cycle memorandum or flowchart format. Having this information prepared in advance will be a great tool for you to refer to during the assessment and audit. This information will also be used by the auditor as part of the audit so you will already have the information prepared. Be sure to identify all systems that have detail that make up the balances being asserted as ready for audit.

Earlier we covered the need to identify and document the procedures, processes, and controls within your entity. This process began in the Discovery and Correction Phase while you were working on the identification of problems and planning corrective actions. It continues and is completed in the Validation Phase.

The instructions also include the criteria used to evaluate whether or not the required action was satisfactorily completed.

Let’s look at these criteria.



Validation Phase (cont.)

Evaluation criteria for Process Cycle Memos and Flow Charts:

- **Accurately describe the regulations followed for the process**
- **Document procedures utilized**
- **Document key control techniques**
- **Identify systems used at the departmental level**
- **Include the management control objectives and risk assessments**

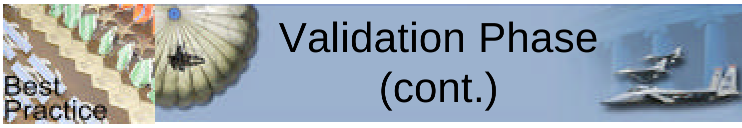
Source: GAO/PCIE FAM at http://www.gao.gov

The evaluation criteria for processing cycle memos and flowcharts state that a flowchart is required for each major process and a cycle/process memorandum should be provided to:

- accurately describe the regulations followed for the process
- document procedures utilized
- document key control techniques identify systems used at the departmental level
- include the management control objectives and risk assessments.

Control techniques/activities are those activities that work to ensure that resources are used consistent with laws, regulation, and policies; are safeguarded against waste, loss, and misuse; and reliable data is obtained, maintained, and disclosed in reports. Examples include passwords, separation of duties, physical security, and span of control, among many others.

You should review the flowcharts, cycle/process memorandum, and supporting documents for reasonableness and completeness for each process listed. The Government Accountability Office, President's Council on Integrity and Efficiency, Financial Audit Manual (GAO/PCIE FAM), Section 390.04, Cycle Memorandum and Flowchart, describes a cycle memorandum. Let's review some best practices for the Validation Phase.



Validation Phase (cont.)

Best practices during the Validation Phase:

- **Think like an auditor**
- **Have a good method for organizing documentation and use document review products such as Electronic Document Access (EDA) or Electronic Document Management (EDM)**
- **Establish audit trails and keep a copy of the database, current output, and reports**
- **Ensure that top management is involved and establish an audit committee or audit interest group**
- **Have good report writers**

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Some best practices may assist you in the validation process. To begin with, think like an auditor. This includes the use of audit checklists, references, and tools that an auditor uses to assess the information that you supply. Procedures used by auditors rarely call for in-depth analysis or complicated calculations. Audit opinions are based on solid research of your policies, practices, and procedures, and the resultant financial information reported.

DoD entities that have obtained unqualified audit opinions, establish clear audit trails. Once audit trails are established, records of tests of documentation procedures can be maintained to substantiate audit readiness. It is a good idea to keep a copy of the database, current output, and reports used in your analysis of financial information. Conclusions drawn using a particular set of data may not be valid when the data changes during the next accounting cycle, though the procedures for gathering that data should not change from one period to the next.

Senior management involvement is critical, and having an audit committee or audit interest group ensures that those personnel who must answer audit inquiries are involved in the process. With their involvement, senior management emphasizes the importance of the effort.

Remember that top management may not have time to review detailed technical data. You must have good report writers to summarize the data presented by technicians, accountants, and analysts.

Now let's look at the Assertion Phase.

Assertion Phase

Management affirms to the DoD OIG the reliability of the financial information

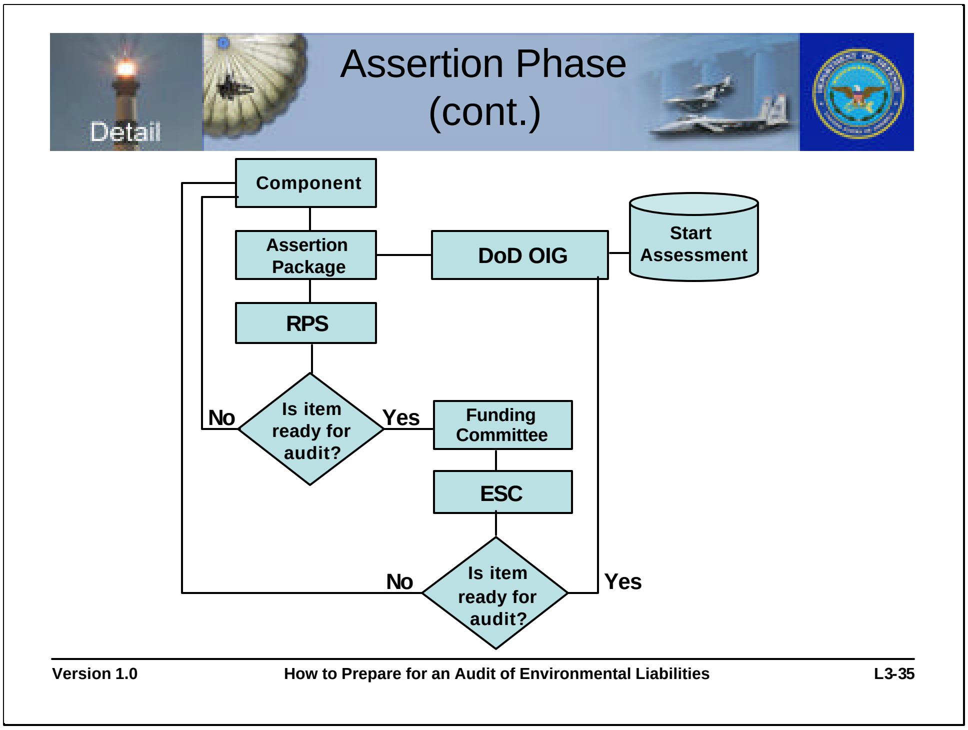
Why	How
Communicate to DoDIG and auditors the reliability of financial information.	Assertion letter to DoDIG, checklist, and results of validation and reports; engagement letter and management representative letter, if used; memo to DoDIG, copy to OUSD(C) RPS; ESC approval required for assessment or audit

Assertions are representations by management that are embodied in the financial statements. They are classified in the five categories: Existence or Occurrence, Completeness, Rights and Obligations, Valuation or Allocation, and Presentation and Disclosure. These will be explained in a moment.

The Assertion Phase notifies the DoD OIG that validation of corrected deficiencies has been completed and that a financial statement or line item is ready for audit. During the Assertion Phase, management prepares an assertion memorandum stating audit readiness and a package of accompanying documentation to support the position of audit readiness.

An auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in your financial statements. After obtaining evidential matter in support of financial statements assertions, the auditors develop audit objectives and design substantive tests for those assertions. These substantive tests are methods used to verify and validate information.

Let's look at the assertion process.



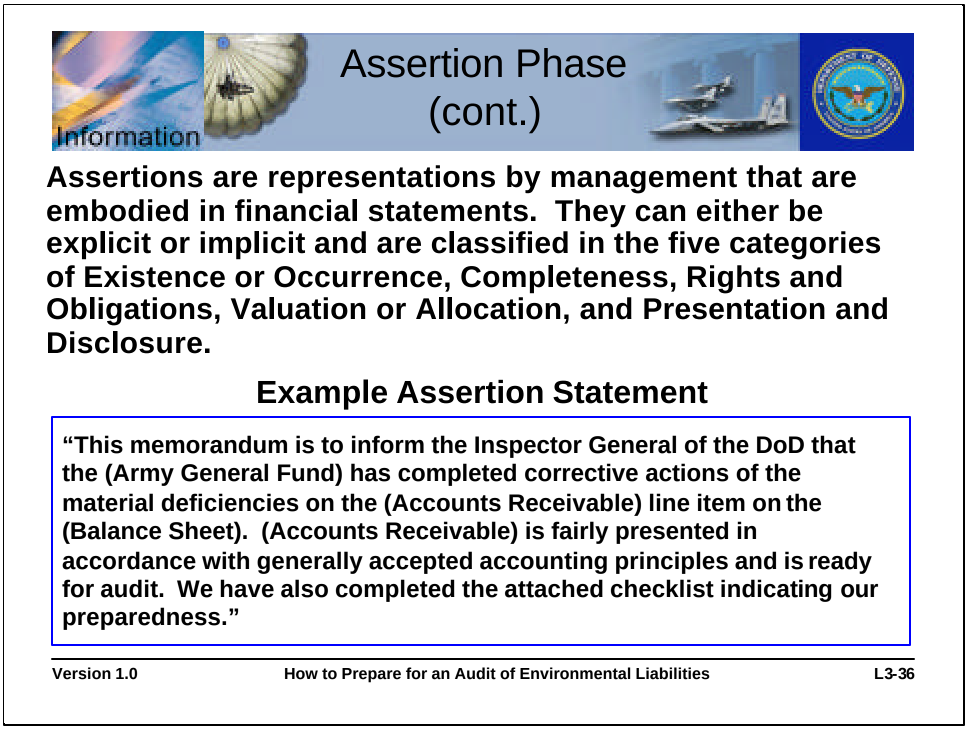
The Component simultaneously submits the assertion package to the RPS and the DoD OIG. The DoD OIG is a non-voting member of the RPS and the ESC. It provides valuable input into the review of the assertion packages to include assessment and audit cost estimates.

If the RPS determines that the assertion package is audit-ready, it is simultaneously submitted to the Funding Committee and the ESC with the RPS's prioritized recommendations concerning assessment and audit schedules.

The ESC, with the Funding Committees' recommendation, reviews the assertion package for audit readiness. If audit-ready, the package is forwarded to the DoD OIG for audit. Once the DoD OIG receives the approved package from the ESC, it may begin the assessment and audit.

If the RPS or ESC makes a determination that the assertion package is not audit-ready, it is returned to the submitting Component.

On the next slide, we define assertions and see a sample assertion statement that management might make.



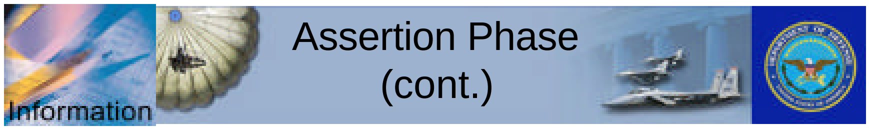
Assertions are representations by management that are embodied in components of the financial statements. They can either be explicit or implicit and are classified in the five categories of: Existence or Occurrence, Completeness, Rights and Obligations, Valuation or Allocation, and Presentation and Disclosure. These will be explained next.

This excerpt of the management assertion letter taken from the USD(C) Memorandum dated June 23, 2004, on Financial Improvement Initiative Business Rules, details the management assertions for the DoD OIG that reads:

“This memorandum is to inform the Inspector General of the Department of Defense that the (i.e.: Army General Fund) has completed corrective actions of the material deficiencies on the (i.e.: Accounts Receivable) line item on the (i.e.: Balance Sheet). (i.e.: Accounts Receivable) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We have also completed the attached checklist indicating our preparedness.”

An auditor’s work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in your financial statements. After obtaining evidential matter in support of financial statements assertions, the auditors develop audit objectives and design substantive tests for those assertions. These substantive tests are methods used to verify and validate information.

Let’s discuss each of the five categories now.



Category One

Existence or Occurrence

- **Example: Management asserts that environmental liabilities on the Balance Sheet physically exist**

Auditors develop tests to verify the assertion

- **Observe that sites/conditions exist for all liabilities shown in Note 14**
- **Confirm environmental liability documentation is supportive of test observations**

Risk

- **Balance Sheet is over/understated**

An assertion made by management about the existence or occurrence addresses whether environmental liabilities exist at a given date and whether recorded transactions have occurred during a given period.

For example, in the existence or occurrence category, management asserts that all of the environmental liabilities included in the Balance Sheet physically exists. The auditors develop substantive tests to verify the assertion made by management. The auditors could observe that sites/conditions exist for all liabilities shown in Note 14, or they can test environmental liability transactions to confirm adequate documentation exists to support their observations.

Let’s discuss the second category.

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Assertion Phase (cont.)

Category Two

Completeness

- **Management asserts all environmental liabilities are on the Balance Sheet**

Auditors conduct tests to verify the assertion

- **Example: completeness of known universe**
- **Example: crosswalk PP&E with environmental liabilities**

Risk

- **Balance Sheet is over/understated**

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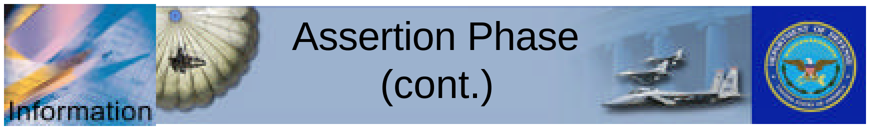
An assertion made by management about completeness addresses whether all environmental liability transactions and accounts that should be presented in the financial statement are included.

For example, the Department asserts that all environmental liabilities are included in their financial statements. Based on this assertion by the Department, the auditors would conduct substantive tests to determine if all of the liabilities are included in the financial statements.

Let's review the third category.



Assertion Phase (cont.)

Category Three

Rights and Obligations

- **Management asserts that all environmental liabilities stated on the Balance Sheet belong only to that entity**

Auditors conduct tests to verify the assertion

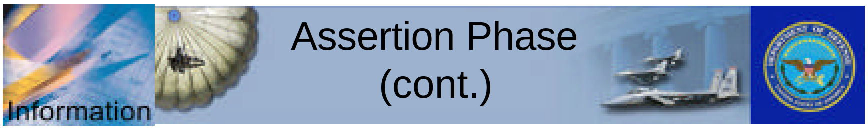
- **Example: review host tenant agreements**

Risk

- **Balance Sheet over/understated**

An assertion made by management about rights and obligations addresses whether environmental liabilities belong to the Department at a given date.

The fourth category, Valuation or Allocation, is discussed next.



Assertion Phase (cont.)

Category Four

Valuation or Allocation

- **Management asserts that environmental liabilities are recorded properly and allocated to the appropriate accounting period**

Auditors conduct tests to verify the assertion

- **Example: parametric models are complete**
- **Example: systematic recognition of liabilities**

Risk

- **Balance Sheet over/understated**

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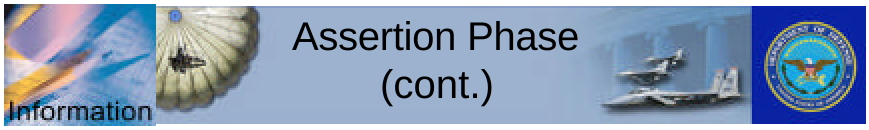
An assertion made by management about valuation or allocation addresses whether the assets, liabilities, equity, revenues, and expenses have all been included in the financial statements at the appropriate amounts. For example, the Department asserts that the environmental liabilities are recorded properly and systematically allocated to the appropriate accounting periods if appropriate. The auditors would ensure that the environmental liabilities were properly estimated and contained appropriate supervisory reviews.

Let's discuss the last category, Presentation and Disclosure.



Assertion Phase (cont.)

Category Five

Presentation and Disclosure

- **Management asserts that amounts presented are properly classified and reflected in Note 14**

Auditors conduct tests to verity the assertion

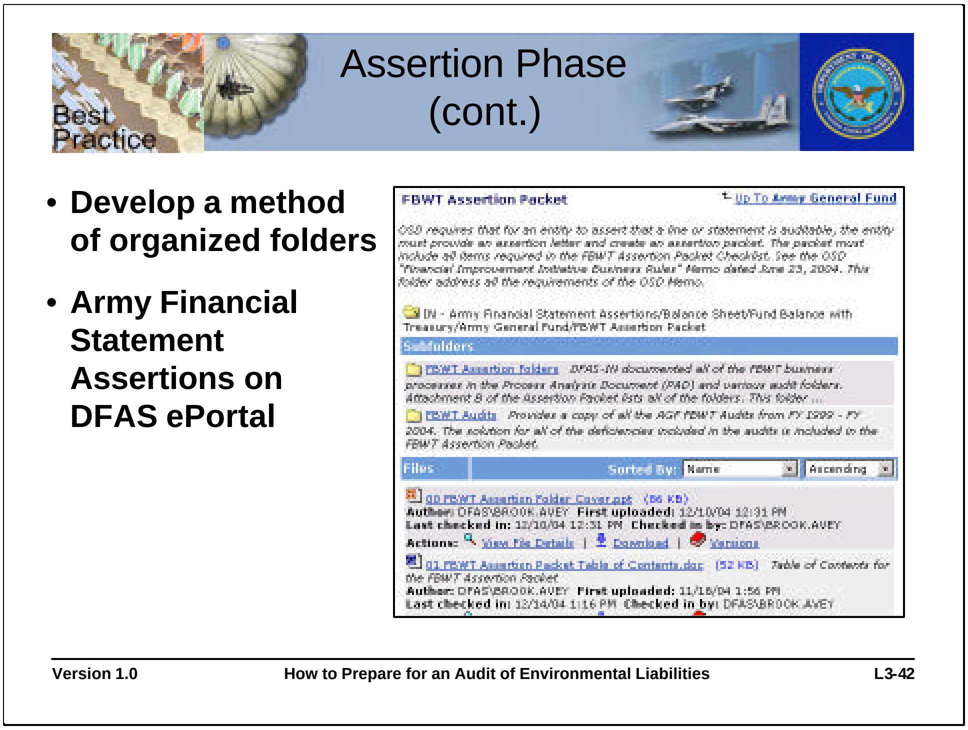
- **Example: sample Note 14 to verify transactions are recorded in correct category**

Risk

- **Balance Sheet line items are over/understated**

An assertion made by management about presentation and disclosure addresses whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts that amounts presented are properly classified and disclosed in Note 14. The auditors analyze the supporting evidential matter for these management assertions.

Let's discuss a best practices related to the Assertion Phase.



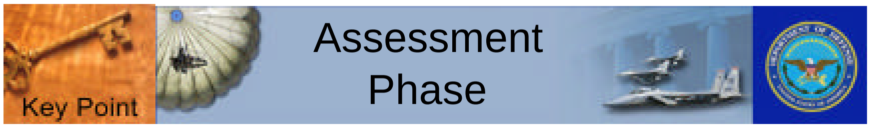
To save time and audit cost, it is important to develop a method of organizing folders so that all assertion data can be retrieved and reviewed quickly and efficiently.

One example of this process is the Army Financial Statement Assertions on the DFAS ePortal. Folders are set up for each of the affected financial statements. Within each statement folder, subfolders are set up for various line items such as Accounts Payable, Cash, Fund Balance With Treasury (FBWT), and others.

Each line item is further subdivided by fund or other applicable division. In the case of FBWT, it is subdivided into folders for the Army General Fund and the Army Working Capital Fund. Once the fund is selected, a subfolder containing FBWT assertion packet information may be opened.

Subfolders in this area are divided into assertion or audit files. Assertion files include a table of contents file and numbered files that are labeled by section and title. Audit files are labeled by Agency and title or report number of the audit reports.

Now let's examine the Assessment Phase.



Assessment Phase

DoD OIG reviews financial information to determine if it is ready for audit

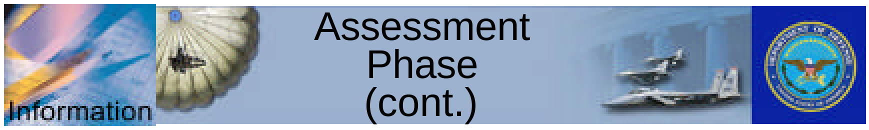
Why	How
Implement 1008, allows remediation, attests to management assertion, plan audit, reduce risk of unknowns to auditor, auditors' introduction to organization	DoDIG oversight of IPAs or DoDIG in-house assessments

The purpose of the Assessment Phase is to determine the reliability of the line item or financial statement that the entity asserts as being ready for audit. It tests internal controls and is the first phase of the audit. If risk is excessive, no audit is performed and the entity returns to correct their errors.

This assessment is substantially less than an audit, but sufficient enough to verify that the corrective actions implemented during the Discovery and Correction Phase successful.

Assessment is generally done first if a statement has never been audited. An example of such a situation is a system of internal control allowing for the disbursement of funds without proper certification. In this case, the DoD OIG determines that an assessment is necessary to ensure reliability as required per Section 1008. During the Assessment Phase, an entity performs a remedy in the event a deficiency is identified preventing an unqualified opinion.

Let's continue with this phase.



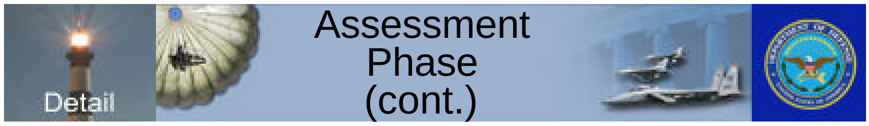
Assessment Phase (cont.)

The scope of the assessment consists of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the Financial Audit Manual (FAM).

The Assessment Phase is performed by the DoD OIG, or by an IPA contracted to perform work for the DoD OIG. The scope of the assessment is determined in accordance with the GAO/PCIE FAM and consists of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase. The assessment process determines whether the entity can likely achieve an unqualified audit opinion. If it is determined that circumstances or problems exist that preclude an unqualified opinion, a report is written to management that describes what has prevented the auditor from obtaining sufficient, reliable, and competent information. The report recommends to management what needs to be accomplished to remedy the problems.

The Assessment Phase is used as part of the DoD OIG's audit strategy to reduce risks of the unknown and introduce new auditors to the entity's processes. Progress is reviewed and monitored by management and the entity's audit committee through regularly scheduled interim progress reports. Management informs its OUSD(C) POC of any new deficiencies identified. There is continued communication, both written and oral, as the assessment progresses. Management should take actions to correct problems identified during the assessment. The DoD OIG recommends when it is appropriate to move forward with a formal audit.

Let's look at a few of the audit steps outlined in the Planning and Internal Control Phases of the FAM.



FAM Planning Phase

200	**PLANNING PHASE**
210	Overview
220	Understand the Entity's Operations
225	Perform Preliminary Analytical Procedures
230	Determine Planning, Design, and Test Materiality
235	Identify Significant Line Items, Accounts, Assertions, and RSSI
240	Identify Significant Cycles, Accounting Applications, and Financial Management Systems
245	Identify Significant Provisions of Laws and Regulations
250	Identify Relevant Budget Restrictions
260	Identify Risk Factors
270	Determine Likelihood of Effective Information System Controls

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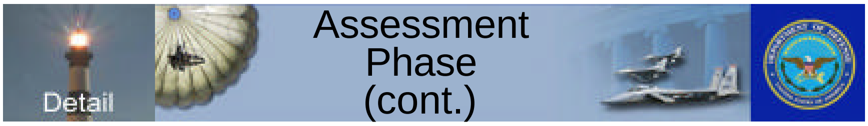
The Planning Phase requires auditors to gain an understanding of the entity's operations, perform preliminary analytical procedures, and determine planning, design, and test materiality. Auditors must also identify significant line items, accounts, and assertions. In gaining an understanding of the entity's operations, auditors identify significant cycles, accounting applications, and financial management systems. They also familiarize themselves with the provisions of laws and regulations, and budget restrictions. Auditors evaluate risk factors and determine the likelihood of effective information systems controls, then identify relevant operations controls to evaluate and test.

The FAM describes the identification of significant cycles, accounting applications, and financial management systems requirements by providing an overview of the auditors' duties as they relate to this item. It defines significance as it relates to each item and how the items are affected by both financial and non-financial systems.

The auditor looks to the entity to provide the needed financial management information to satisfy this phase.

Now let's talk about the Internal Control Phase.



FAM Internal Control Phase

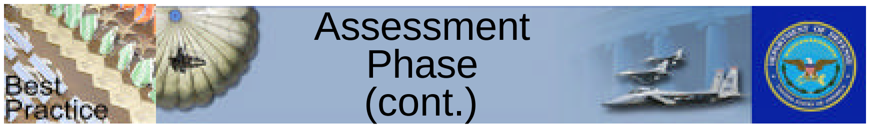
300	**INTERNAL CONTROL PHASE**
310	Overview
320	Understand Information Systems
330	Identify Control Objectives
340	Identify and Understand Relevant Control Activities
350	Determine the Nature, Timing, and Extent of Control Tests and of Tests for Systems' Compliance with FFMIA Requirements
360	Perform Nonsampling Control Tests and Tests for Systems' Compliance with FFMIA Requirements
370	Assess Controls on a Preliminary Basis
380	Other Considerations
390	Documentation

The Internal Control Phase requires auditors to gain an understanding of the entity's information systems, control objectives, and relevant control activities. They must determine the nature, timing, and extent of control tests and of tests for systems compliance with legal requirements. To determine the testing required, auditors perform control and compliance testing on a preliminary basis.

Relevant control activities are described as those that are designed to achieve the specific control objective. The auditors first screen the activities to identify those objectives that are effective and efficient. They do this to obtain a sufficient understanding of the identified control activities. The auditors must determine whether it is likely that the control objectives can be achieved, assuming an effective control environment, risk assessment, communications, monitoring, appropriate segregation of duties, and effective general controls.

The auditors identify any weaknesses in specific control activities that should be corrected. When internal control components are poor or insufficient, this can signal inadequate segregation of duties. Poor general controls preclude the effectiveness of specific control activities that would otherwise be effective. The testing of these control activities may be limited to determining whether they are in place.

Let's examine a few practices that are particularly useful in the Assessment Phase.



Best Practices in Assessment Phase

- **Know the audit process and the regulations**
- **Provide good training and awareness for all staff**
- **Change the mindset toward audits**
- **Know the auditor's checklist**
- **Staff resources to work with auditors**

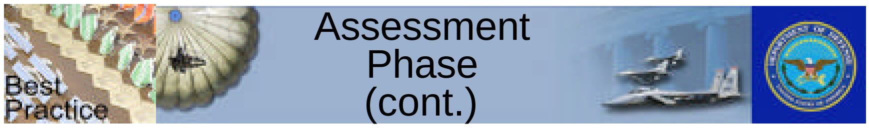
If you know the audit process and the regulations driving it, you can anticipate the auditor's requirements. It is important that good training and awareness for all staff is included in your assessment strategy. With adequate training on what is expected, you ensure that your people are ready for the audit.

You must lead a change in the mindset toward audits; they are not just for the financial community. You may set up a web site or have a newsletter. Frequent communication is necessary to convey expectations, goals, and direction.

When the auditors examine entity operations, you should know the auditor's checklist. You can then anticipate what is going to be needed and start early to have the audit move quickly with less disruption of business operations.

Successful organizations ensure that they have adequate resources in place to assist in the audit effort. You must assign resources to work with auditors or hire contractors.

Let's continue with more best practices.



Assessment Phase (cont.)

Best Practices in Assessment Phase (cont.)

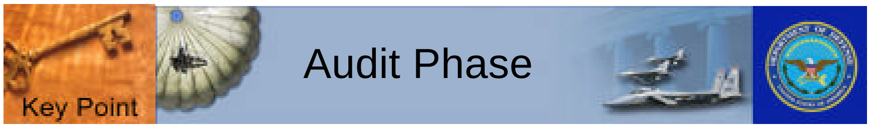
- **Educate/train for audit involvement**
- **Have document retrieval methods documented**
- **Have consistent practices**

It’s important to develop people with the right skill set to work with auditors. If not, the process slows down considerably. Auditors will ask the most available person questions concerning your entity’s operations, controls, and procedures. You must ensure that the most available person is also the most knowledgeable person.

Document retrieval methods may be established for both paper and electronic documents. You must have document retrieval methods established and documented, especially for historical data. Ledgers containing all transactions should be ready and should include all documentation and back-up matter. This matter may include purchase orders, invoices, receiving reports, and other essential documentation. This source documentation may be located in several different offices. It must be pulled together to support the financial records.

Auditors are looking for consistent practices that are within established guidelines.

Let’s move on to the Audit Phase.



Audit Phase

DoD OIG audits the organization's financial statements that management asserted were ready for audit and that passed the DoD OIG assessment

Why	How
Implement CFO Act, implement 1008 President's Management Agenda. Additionally, the GMRA supplements the CFO Act.	Pass assessment, DoDIG oversight of IPAs or DoDIG in-house audits

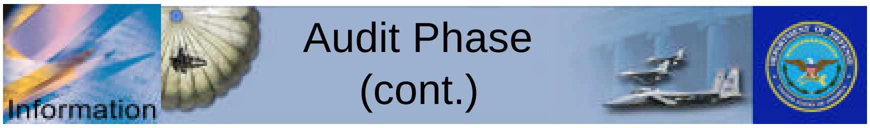
During the Audit Phase, the entity and its accounting records are audited to determine if the balances and related notes presented on its financial statements fairly represent the operations of the entity.

With the assistance of the DoD OIG, DoD reporting entities prepare detailed engagement letters requesting audit services. The auditors then require any management representations made to date that concern the items to be included in the audit. DoD reporting entities prepare as many interim management representation letters as necessary to include any additional assertions required by the audit. They then prepare a final management representation letter.

Management personnel address deficiencies with a written plan for resolution, including projected resolution date. The DoD OIG intervenes if necessary to end the audit and recommends a follow-up assessment upon indication that the audit may not have a favorable outcome.

The scope of the Audit Phase consists of accomplishing the audit steps outlined in the Testing Phase and Reporting Phase of the audit manual.

Let's look at a few of these steps.



Testing Phase

- **Auditors consider the nature, timing, and extent of tests**
- **Tests must provide the greatest benefit for the least amount of time and resources**

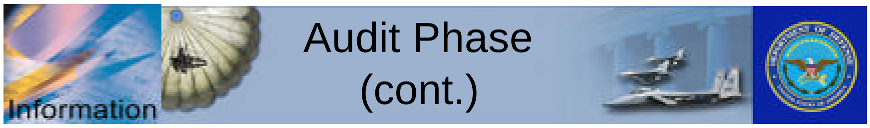
400	TESTING PHASE
410	Overview
420	Consider the Nature, Timing, and Extent of Tests
430	Design Efficient Tests
440	Perform Tests and Evaluate Results
450	Sampling Control Tests
460	Compliance Tests
470	Substantive Tests – Overview
475	Substantive Analytical Procedures
480	Substantive Detail Tests
490	Documentation

The Testing Phase consists of a consideration of the nature, timing, and extent of tests to be performed on the evidentiary matter associated with the audit. The auditor must design efficient tests that provide the greatest benefit for the least amount of time and resources. The auditor must then perform those tests and evaluate results. Several types of testing are available and are explained within the FAM.

The How to Manage Audit Evidential Matter course provides additional information concerning audit testing methods.

Once testing is completed, the auditor must document the results in order to ensure that adequate audit procedures have been accomplished.

Let's look at the requirement for performing tests and evaluating results.



Testing Phase (cont.)

- **Evaluate the results of each type of test separately**
- **Tests performed with the expectation of obtaining certain results may give other results**

Testing Phase

440 - PERFORM TESTS AND EVALUATE RESULTS

.01 The auditor should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. Guidance on performing and evaluating the results is presented for each type of test in the following sections

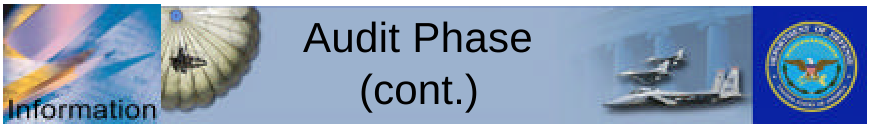
- Section 450 - Sampling control tests,
- Section 460 - Compliance tests, and
- Section 470 - Substantive tests.

.02 Sometimes, tests performed with the expectation of obtaining certain results give other results. When this happens, the auditor may wish to expand a sample to test additional items. Unless planned for in advance, this generally cannot be done simply, as discussed in paragraphs 450.17, 460.02, and 480.28; the auditor should consult with the Statistician in such cases.

The FAM states that the auditor should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. It states that sometimes, tests performed with the expectation of obtaining certain results give other results.

When this happens, the auditor may wish to expand a sample to test additional items. Unless planned for in advance, this generally cannot be done simply and the auditor should consult with a statistician.

Let’s discuss the Reporting Phase.



Reporting Phase

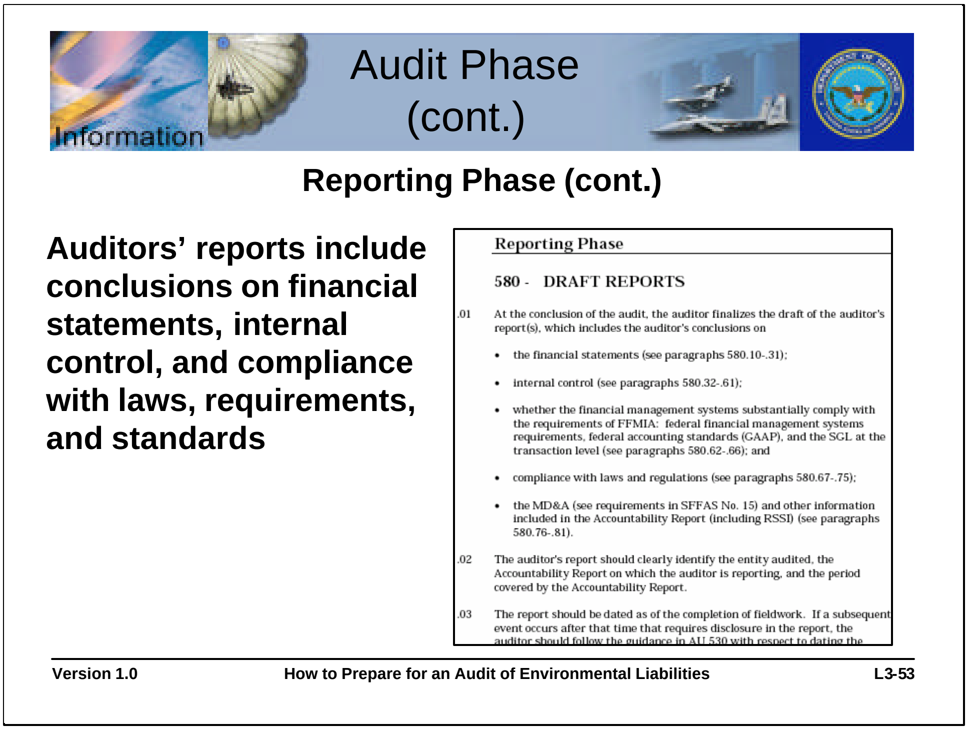
500	REPORTING PHASE
510	Overview
520	Perform Overall Analytical Procedures
530	Determine Adequacy of Audit Procedures and Audit Scope
540	Evaluate Misstatements
550	Conclude Other Audit Procedures • Inquiries of Attorneys • Subsequent Events • Management Representations • Related Party Transactions
560	Determine Conformity With Generally Accepted Accounting Principles
570	Determine Compliance With GAO/PCIE Financial Audit Manual
580	Draft Reports

The Reporting Phase requires the auditor to perform overall analytical procedures. This does not mean that all testing must be re-done, but that the results of all of the testing must be analyzed in order to formulate conclusions. The auditor must also determine the adequacy of audit procedures and the audit scope in the formulation of these conclusions.

Misstatements are evaluated for their severity. If material, they may affect the overall opinion of the auditor. Other audit procedures include inquiries of the attorneys who represent the entity. Auditors must determine whether there are any pending liabilities that were not adequately disclosed in the notes to the financial statements.

The auditor must determine whether the presentation of the financial statements is in conformity with GAAP and whether the entity is in compliance with the FAM. The auditor then drafts reports on the financial statements, internal control, financial management systems, and compliance with laws and regulations.

Let’s expand on the drafting of these reports.

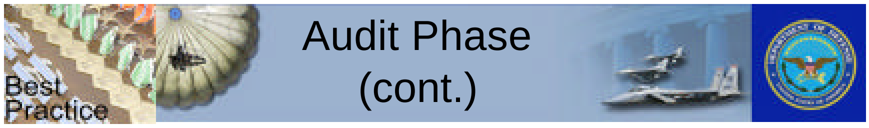


At the conclusion of the audit, the auditors finalize the draft of the reports. They include the auditors’ conclusions on the financial statements, internal control, and system compliance with requirements of the Federal Financial Management Improvement Act (FFMIA), federal financial management systems requirements, federal accounting standards, and the United States Government Standard General Ledger (USSGL) at the transaction level. They also include the auditors’ conclusions on the entity’s compliance with laws and regulations.

The auditors’ report will identify the entity audited, the accountability report on which the auditor is reporting, and the period covered by the accountability report. It will be dated as of the completion of fieldwork.

The final report is based upon the financial documents that the entity provided. If the information is inaccurate or incomplete, the report may mistakenly portray an unfavorable picture of the entity.

Let’s consider a few best practices.



Best Practices during the Conduct of the Audit

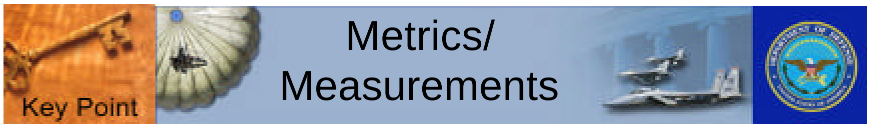
- **Plan the entrance conference**
- **Maintain communications with POCs and employees**
- **Monitor information consistently and keep track**

An audit should contain no surprises. Once you have engaged an auditor, you must plan for the entrance conference. Ensure that adequate and knowledgeable staff is available, that adequate time is scheduled without interruption, and that a congenial atmosphere is maintained. Be familiar with the areas to be audited and know the procedures used to test those areas.

You must communicate audit requirements with your POCs and employees to ensure a smooth audit process. Knowledgeable personnel must be available to the auditor throughout the audit. By having a proper escort, the auditor's questions are likely to be answered correctly, and there is less likelihood of delays in the conduct of the audit.

Information obtained in the audit process should be monitored, appropriately catalogued, and filed for immediate or later action.

Next we discuss metrics and measurements.



Metrics/ Measurements

What are metrics/measurements?

Tangible measurements used to develop realistic estimates and plans, to objectively track and communicate program and project status, and to anticipate problems or identity risks.

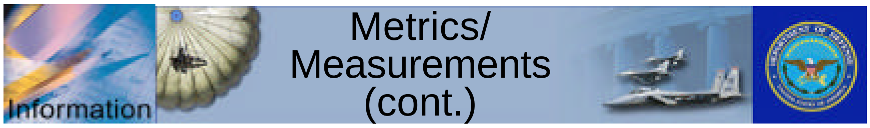
Metrics are actionable and tangible measurements that support objectives and demonstrate an entity’s accountability. They include objectives, measures, and targets.

The objectives define what the entity needs to do in order to accomplish its strategy. Measures are the metrics and the targets are the performance level expectations. For each metric, the Department should set a goal or plan so the progress against the objective can be evaluated.

Tracking metrics provides historical data to help plan and predict future programs/projects and provides baseline information to support decision making.

The Department is using metrics and measurements to help solve the environmental liability deficiencies through use of the Financial Improvement and Audit Readiness (FIAR) Plan.

Let’s discuss it now.



Metrics/ Measurements (cont.)

The Financial Improvement and Audit Readiness (FIAR) Plan provides a roadmap for financial improvement activities and auditability. The plan provides visibility of key actions by quarter.

The FIAR Plan's focus on environmental liabilities is important to management because it:

- **Improves the reliability of Operations and Maintenance (O&M) resources required for environmental liabilities**
- **Significantly impacts on Balance Sheet liabilities**

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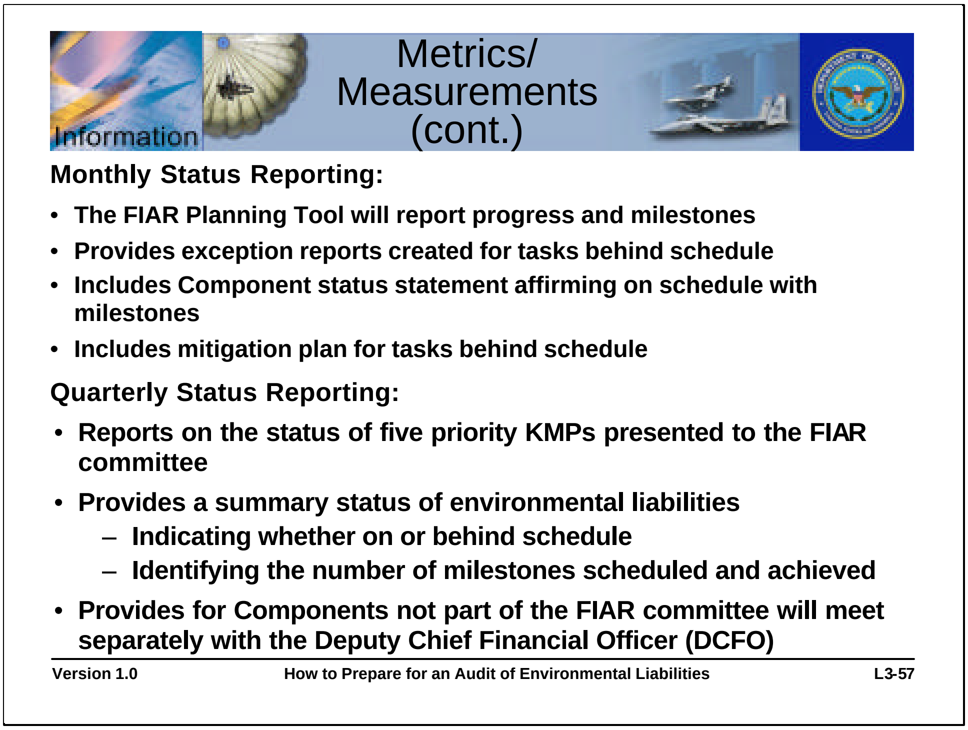
The FIAR Plan uses metric and measurements to provide visibility of key actions necessary to solve the environmental liability deficiencies. If you're not clear why all this attention is being focused on environmental liabilities, maybe this will help. Environmental liabilities provided value to management as they improve the:

- visibility of the government's liability
- visibility of resources and funding to accurately state environmental liabilities caused by past or on-going programs that accurately represent the extent of the resources required to clean-up environmental damage
- ability to forecast funding requirements
- ability to use existing environmental liability costs to better forecast the future life-cycle costs for future projects with potential liabilities.

Let look at specific reporting requirements for the FIAR Plan.



The benefits of using metrics and measurements to help solve the Department's environmental deficiencies are several. They provide visibility and help mitigate risk. Additionally, much of the process is automated negating the need to create separate reports. Reports are pulled monthly or quarterly through the FIAR Planning Tool. Each plan receives high-level view and allows for a coordinated execution.

The bottom line is that although much has been accomplished to remedy the deficiency, the Department has not identified and estimated all environmental liabilities. Much is yet to be done.

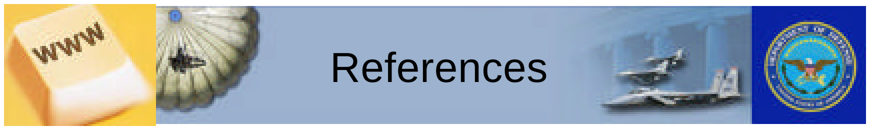
Let's review the lesson on the next slide.

In this lesson, you learned the roles and responsibilities of various parties associated with an audit of the financial statements. We discussed that your organization's audit liaison team is a key ingredient to a successful audit. We discussed the five phases of the Financial Improvement Initiative Business Rules.

You learned the Discovery and Correction Phase is intended to allow you to correct deficiencies and plan how to prevent them from recurring. We also discussed that in the Validation Phase you can validate the corrections made and enhance the credibility of the assertions. We said the Assertion Phase lets the DoD OIG know you are ready for an audit. You further learned that during this phase, management designates staff to work with the auditors and that documentation has been reviewed and is available to support the audit. During this important phase, the Assertion Package is submitted to the DoD OIG. You learned the Assessment Phase attests to management's assertions and prepares for an audit. When everything is approved the audit is scheduled. We discussed that the Audit Phase is required by the President's Management Agenda and the CFO Act.

We ended the lesson with a look at the how metrics and measurements are developed from the organization's strategy. You also learned that by setting high standards we establish accountability and an expectation of superior results.

The following slide lists references available for additional information.



DoDFMR: http://www.dod.mil/comptroller/fmr/

GAO/PCIE FAM:
http://www.gao.gov/special.pubs/gaopcie/

OMB Circular A-123:
http://www.whitehouse.gov/omb/circulars/a123/a123.html

Questions

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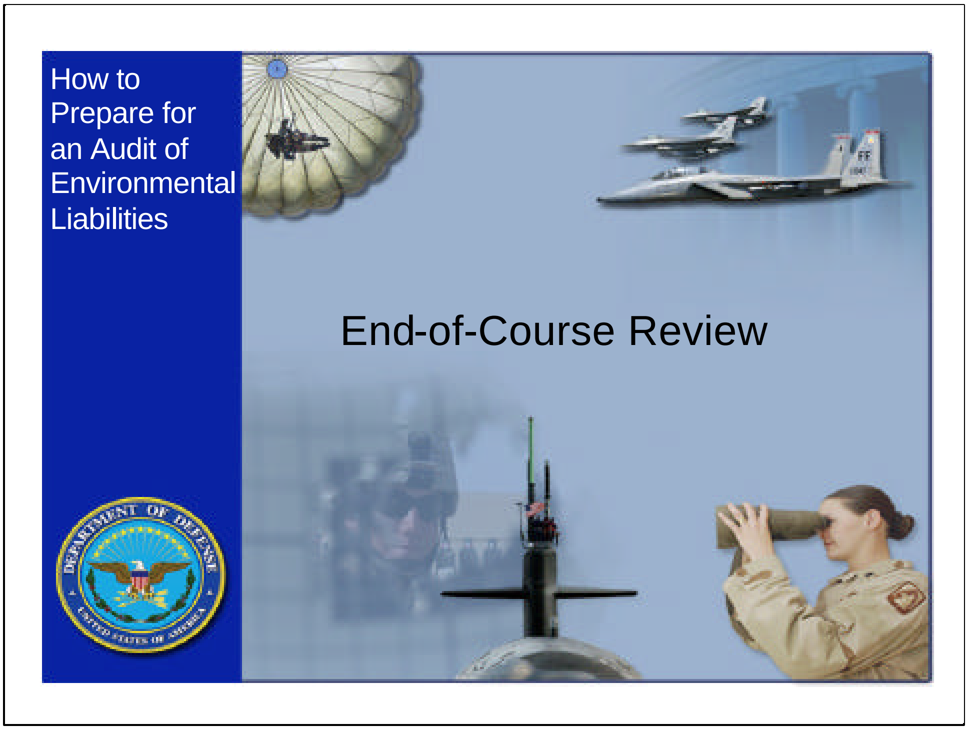
Before we move on to the End-of-Course Review, do you have any questions on the material covered in this lesson?



You should now be able to analyze components of environmental liabilities on the DoD financial statements. Recall that we discussed the use of Note 14, as well as the Balance Sheet. We explained supporting documentation for environmental liabilities like cost estimates. We also examined the documentation that must be available to support the financial statement audit throughout the audit trail. Finally, we described how available tools, such as checklists, help achieve audit compliance.

Let's review each of the lessons beginning with Lesson 1, Identifying Critical Components of Environmental Liabilities.

Lesson 1, Identifying Critical Components of Environmental Liabilities:

- **Legal and Regulatory Requirements**
- **Environmental Liabilities**
- **Proof of Statements and Checklist Integrity**
- **DERP**
- **Non-DERP Liabilities and Their Impact**

We began the lesson with a discussion on the legal and regulatory requirements for supporting documentation. One key source, the CFO Act, requires financial management systems and accounting data. A key source related to environmental liabilities is the cost estimates developed by non-DFAS personnel.

We defined an environmental liability as a legal obligation to make future expenditures related to a past activity that adversely affected the environment. We said to establish an environmental liability, it must be both probable and estimable. Probable indicates the liability is more likely than not to occur and estimable speaks to whether we have experience with similar liabilities and whether there is current technology to remediate the problem.

In the Proof of Statements topic, we discussed that during an audit, amounts shown on the financial statements are verified through an examination of sample data and other evidence. We talked about the Balance Sheet and Note 14. You observed how the Balance Sheet is a snap shot of the organization's assets, liabilities, and net position. Here we also learned that Note 14 contains environmental liabilities. The FAM was observed to have checklists developed for auditors but also serves as useful tools for you to provide integrity to the financial statements.

You learned how to determine a DERP or non-DERP liability by using the steps provided. In general, we said that if activity that created the environmental liability is funded through the DERP, then the liability should be handled in accordance with DERP policies and procedures. However, if the activity that created the environmental liability receives funding from sources other than the DERP, the liability should be handled in accordance with non-DERP policies and procedures.

Lesson 1, Identifying Critical Components of Environmental Liabilities (cont.):

- **Internal Control**
- **General Ledger Accountability of Environmental Liabilities**

While discussing internal control, you learned they should be integrated throughout the entity as they are an integral part of planning, implementing, and reviewing. You learned pertinent guidance and found the OMB Circular A-123 and Appendix A, examines controls used in organizations to establish policies and procedures; to assist in achieving desired results; and to safeguard the integrity of programs. We looked at examples of internal control and saw the importance of items such as the checklist used by supervisors to review and approve estimates.

And finally, our discussion of General Ledger accountability showed when potential environmental liabilities are at least reasonably possible, they should be disclosed in Note 14 of the financial statements. You also learned that fund availability is not a prerequisite for recognizing an environmental liability. We discussed that one key source for entries into the accounting records are environmental cost estimates.

Let's review Lesson 2, Documenting Transactions for Environmental Liabilities.

Lesson 2, Documenting Transactions for Environmental Liabilities (cont.):

- **Types of Supporting Documentation**
- **Documentation for Engineering Estimates of Liabilities**
- **Audit Trails**
- **EDA**

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We began this lesson by examining the types of supporting documentation used to support a financial statement audit. You learned that the supporting documentation is evidential matter consisting of accounting data and all corroborating information. Typical examples includes cost estimates and management reviews, permits and approvals, contracts, invoices, and disbursement documents, and other third-party documentation.

We then examined the documentation for engineering estimates of liabilities. We noted that organizations preparing estimates must retain adequate documentation to identify their data sources, estimating methods, rationale used, and management reviews. One key source of documentation is that produced by RACER; however, we learned that a summary document is necessary to ensure all supporting documentation is verifiable.

In our discussion of audit trails, you learned the DoDFMR requires adequate documentation be maintained for an effective audit trail. Audit trails refer to cost-to-complete estimates and other documents, journals, ledgers, worksheets, reports, statements, and so forth, by which an original transaction can be traced forward to a summarized total, or a summarized total can be followed back to the original transaction.

You learned that support documents are found in both paper and electronic format and that documents scanned into an electronic medium, or those created electronically, may be authorized to act as official documents.

Let's review Lesson 3, Using Tools to Prepare for Audits of Environmental Liabilities.

Lesson 3, Using Tools to Prepare for Audits of Environmental Liabilities:

- **Roles and Responsibilities**
- **Audit Readiness Business Rules**
- **Discovery and Correction Phase**
- **Validation Phase**

We discussed the roles and responsibilities of the auditor, the audit liaison team members, managers, DoD reporting entities, and DFAS in relation to what is required at each phase of the audit preparation. We also noted that in addition to individual roles and responsibilities, there are some that apply to everyone. For example, we must ensure there is adequate evidential documentation and we should understand the numbers reported on our financial information sufficiently to be able to explain abnormalities and normal fluctuation.

During our discussion of business rules for an audit, we previewed each of the five phases, Discovery and Correction, Validation, Assertion, Assessment, and Audit. Next, you learned that the Discovery and Correction Phase is intended to allow you to correct deficiencies and plan how to prevent them from recurring. During discovery, you identify obstacles that could prevent the entity from obtaining an unqualified audit opinion and to prepare improvement plans with solutions that have measurable outcomes for overcoming those obstacles. Correction requires DoD entities to implement solutions within the milestone dates prescribed, resulting in a resolution of the identified deficiency.

You also learned the Validation Phase validates the effectiveness of the corrective actions. Validation determines whether sufficient controls and transaction information are available to support management's assertion that the line or financial statements are ready for audit, and ensures that supporting documentation is available during the audit.

Lesson 3, Using Tools to Prepare for Audits of Environmental Liabilities (cont.):

- **Assertion Phase**
- **Assessment Phase**
- **Audit Phase**
- **Metrics/Measurements**

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We discovered that the Assertion Phase lets the DoD OIG know you are ready for an audit, that is, that management has designated staff to work with the auditors and that documentation has been reviewed and is available to support the audit. This is accomplished by submission of the Assertion Package to the DoD OIG.

You learned the Assessment Phase determines the reliability of the line item or financial statement that the entity asserts as being ready for audit. This assessment is substantially less than an audit, but sufficient enough to verify the corrective actions implemented during the Discovery and Correction Phase. Assessment is done if the DoD OIG believes circumstances may exist that will cause the entity to obtain an opinion other than unqualified.

We discussed the purpose of the Audit Phase is to obtain an auditor's opinion of the condition of an entity's financial statement or line and the fairness of the presentation of the information in the financial statements.

Lesson 3 ended with a discussion of metrics/measurements. We saw how they are developed from the top down and should encompass the strategy and objectives of the organization.

Let's continue with the course final examination.

Appendix A. Glossary

This glossary should serve as a reference tool for DoD personnel who need an understanding of auditing terminology related to environmental liabilities. It is not all-inclusive and reflects both acronyms and terms introduced throughout this course.

AST	Aboveground Storage Tank
AU	Auditing Standards
BD/DR	Building Demolition/Debris Removal
BMMP	Business Management Modernization Program
BRAC	Base Realignment and Closure
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
CFO	Chief Financial Officer
CIP	Construction in Progress
CPA	Certified Public Accountant
DCFO	Deputy Chief Financial Officer
DERA	Defense Environmental Restoration Account
DERP	Defense Environmental Restoration Program
DFAS	Defense Finance and Accounting Service
DISA	Defense Information Systems Agency
DLA	Defense Logistics Agency
DMM	Discarded Military Munitions
DON	Department of Navy
DoD	Department of Defense (also referred to as the Department)
DoDD	Department of Defense Directive
DoDFMR	Department of Defense Financial Management Regulation
DoDI	Department of Defense Instruction

DoD OIG	Department of Defense, Office of Inspector General
EDA	Electronic Document Access
EDM	Electronic Document Management
ER	Environmental Restoration
ESC	Executive Steering Committee
FAM	Financial Audit Manual
FASAB	Federal Accounting Standards Advisory Board
FBWT	Fund Balance With Treasury
FFA	Federal Facility Agreement
FFMIA	Federal Financial Management Improvement Act
FinPlan	Financial Plan
FIS	Facilities Information System
FISCAM	Federal Information System Controls Audit Manual
FMFIA	Federal Managers Financial Integrity Act
FMR	Financial Management Regulation
FUD	Formerly Used Defense site
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAO	Government Accountability Office
GL	General Ledger
GMRA	Government Management Reform Act
GPRA	Government Performance and Results Act
GRS	General Records Schedule
IAG	Inter-agency Agreement

IAP	Installation Action Plan
IPA	Independent Public Accountant
IRA	Interim Remedial Action
IRP	Installation Restoration Program
JV	Journal Voucher
KMP	Key Milestone Plan
Liability	An amount owed for items or services received and expenses incurred
LRA	Local Redevelopment Authority
LTM	Long Term Management
LUC	Land Use Control
MCP	Management Control Program
MCS	Munitions Constituents
MMRP	Military Munitions Response Program
NARA	National Archives and Records Administration
NAVFAC	Navy Facility Engineering Command
NERP	Navy Environmental Restoration Program
NPDES	National Pollution Discharge Elimination Systems
NPL	National Priorities List
NROM	Normalization of Environmental Data
NRV	Net Realizable Value
ODUSD(I&E)	Office of the Deputy Under Secretary of Defense, Installations and Environment
OEA	Office of Economic Adjustment
OMB	Office of Management and Budget
OSD	Office of the Secretary of Defense

OUSD(C)	Office of the Under Secretary of Defense, Comptroller
PAR	Performance and Accountability Report
PBC	Prepared by Client
PCIE	President's Council on Integrity and Efficiency
PMA	President's Management Agenda
POC	Point of Contact
POL	Petroleum, Oil, and Lubricant
POTW	Publicly Owned Treatment Works
PP&E	Property, Plant, and Equipment
R&D	Research and Development
RA	Remedial Action
RAB	Restoration Advisory Board
RACER	Remedial Action Cost Engineering Requirements
RA-O	Remedial Action-Operation phase
RC	Response Complete
RCRA	Resource Conservation and Recovery Act
RIFS	Remedial Investigation/Feasibility Study
RIP	Remedy in Place
RPS	Review and Prioritization Subcommittee
ROD	Record of Decision
RPM	Remedial Project Manager
SARA	Superfund Amendments and Reauthorization Act
SecDEF	Secretary of Defense
SFFAS	Statement of Federal Financial Accounting Standards
SGL	Standard General Ledger

Superfund	Term used to refer to the Comprehensive Environmental Response, Compensation, and Liability Act
U.S. or US	United States
ULO	Unliquidated Obligation
USACE	U.S. Army Corps of Engineers
USC	United States Code
USSGL	United States Government Standard General Ledger
UST	Underground Storage Tank
UXO	Unexploded Ordnance
WMM	Waste Military Munitions

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Appendix B. Excerpts from the 2004 PAR

This appendix contains the Department's Consolidated Balance Sheet, along with Notes 14 and 15 from the annual financial statements. This financial statement and notes is found in the 2004 Performance and Accountability Report (PAR). Additional copies of the Balance Sheet and Note 14 are included in the back of the appendix and can be torn out if students wish to follow along during class.

Department of Defense
Agency Wide
CONSOLIDATED BALANCE SHEET
As of September 30, 2004 and 2003
($ in Millions)

		2004 Consolidated		2003 Consolidated Restated
ASSETS (Note 2)				
Intragovernmental:				
Fund Balance with Treasury (Note 3)				
Entity	$	287,685.5	$	251,544.1
Non-Entity Seized Iraqi Cash		113.4		278.1
Non-Entity-Other		1,800.0		239.8
Investments (Note 4)		231,069.7		205,376.0
Accounts Receivable (Note 5)		1,118.3		1,066.6
Other Assets (Note 6)		1,011.9		105.0
Total Intragovernmental Assets	$	522,798.8	$	458,609.6
Cash and Other Monetary Assets (Note 7)	$	2,178.1	$	1,534.9
Accounts Receivable (Note 5)		7,427.8		7,299.9
Loans Receivable (Note 8)		70.7		64.0
Inventory and Related Property (Note 9)		213,219.4		205,544.6
General Property, Plant and Equipment (Note 10)		440,898.6		446,308.9
Investments (Note 4)		406.5		217.8
Other Assets (Note 6)		21,486.3		21,729.6
TOTAL ASSETS	$	1,208,486.2	$	1,141,309.3
LIABILITIES (Note 11)				
Intragovernmental:				
Accounts Payable (Note 12)	$	1,888.4	$	101.4
Debt (Note 13)		591.8		698.2
Environmental Liabilities (Note 14)		0.0		0.0
Other Liabilities (Note 15 & Note 16)		10,726.9		9,739.1
Total Intragovernmental Liabilities	$	13,207.1	$	10,538.7
Accounts Payable (Note 12)	$	28,309.0	$	27,863.8
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 17)		1,569,704.7		1,429,565.5
Environmental Liabilities (Note 14)		64,367.2		61,490.6
Loan Guarantee Liability (Note 8)		34.4		25.9
Other Liabilities (Note 15 and Note 16)		34,491.2		30,154.0
Debt Held by Public		0.0		0.0
TOTAL LIABILITIES	$	1,710,113.6	$	1,559,638.5
NET POSITION				
Unexpended Appropriations (Note 18)	$	243,813.9	$	218,869.5
Cumulative Results of Operations		(745,441.3)		(637,198.7)
TOTAL NET POSITION	$	(501,627.4)	$	(418,329.2)
TOTAL LIABILITIES AND NET POSITION	$	1,208,486.2	$	1,141,309.3

Note 14.	**Environmental Liabilities and Disposal Liabilities**

As of September 30	2004			2003
	Current Liability	Noncurrent Liability	Total	Total
(Amounts in millions)				
1. Environmental Liabilities – Non Federal				
A. Accrued Environmental Restoration (DERP funded) Costs:				
1. Active Installations--Environmental Restoration (ER)	$1,752.0	$9,116.2	$10,868.2	$11,833.8
2. Active Installations--ER for Closed Ranges	63.3	7,645.7	7,709.0	4,362.1
3. Formerly Used Defense Sites (FUDS) -- ER	341.0	3,980.3	4,321.3	4,239.4
4. FUDS--ER for Transferred Ranges	149.3	13,935.0	14,084.3	13,624.4
B. Other Accrued Environmental Costs (Non-DERP funds)				
1. Active Installations--Environmental Corrective Action	52.3	517.3	569.6	561.0
2. Active Installations--Environmental Closure Requirements	16.0	162.5	178.5	103.6
3. Active Installations--Environ. Response at Active Ranges	62.5	217.1	279.6	276.3
4. Other	0.4	8.8	9.2	50.0
C. Base Realignment and Closure (BRAC)				
1. BRAC Installations--Environmental Restoration (ER)	670.6	2,450.3	3,120.9	3,616.6
2. BRAC Installations--ER for Transferring Ranges	11.3	524.6	535.9	511.6
3. BRAC Installations--Environmental Corrective Action	15.3	152.5	167.8	187.9
4. Other	209.3	0.0	209.3	190.4

D. Environmental Disposal for Weapons Systems Programs				
1. Nuclear Powered Aircraft Carriers	0.0	5,693.0	5,693.0	5,565.0
2. Nuclear Powered Submarines	42.4	5,146.3	5,188.7	4,888.9
3. Other Nuclear Powered Ships	86.5	201.0	287.5	269.1
4. Other National Defense Weapons Systems	5.8	266.1	271.9	297.1
5. Chemical Weapons Disposal Program	1,096.9	9,672.6	10,769.5	10,810.3
6. Other	103.0	0.0	103.0	103.1
2. Total Environmental Liabilities:	$ 4,677.9	$ 59,689.3	$ 64,367.2	$ 61,490.6

Service Component – Environmental Restoration (Clean up) Liabilities and Environmental Disposal Liabilities (Amounts in millions)	Army	Navy	Air Force	ODO
1. Environmental Liabilities:				
A. Non-Federal:				
1. Accrued Environmental Restoration (Defense Environmental Restoration Program (DERP) funded) Costs:				
a. Active Installations-Environmental Restoration (ER)	$ 3,520.4	$ 2,841.5	$ 4,225.2	$ 281.1
b. Active Installations--ER for Closed Ranges	5,781.1	583.0	1,344.9	
c. Formerly Used Defense Sites (FUDS) –ER	4,321.3			
d. FUDS--ER for Transferred Ranges	14,084.3			
2. Other Accrued Environmental Costs (Non-DERP funds)				
a. Active Installations--Environmental Corrective Action	259.0		182.4	128.2
b. Active Installations--Environmental Closure Requirements	51.2		112.3	15.0
c. Active Installations--Environ. Response at Active Ranges	267.6			12.0
d. Other				9.2
3. Base Realignment and Closure (BRAC)				
a. BRAC Installations--Environmental Restoration (ER)	597.4	1,110.7	1,379.7	33.1
b. BRAC Installations--ER for Transferring Ranges	480.1	55.8		
c. BRAC Installations--Environmental Corrective Action	25.0		142.8	
d. Other	209.3			
4. Environmental Disposal for Weapon Systems Programs				
a. Nuclear Powered Aircraft Carriers		5,693.0		
b. Nuclear Powered Submarines		5,188.7		
c. Other Nuclear Powered Ships		287.5		
d. Other National Defense Weapon Systems		271.9		

		271.9		
e. Chemical Weapons Disposal Program	10,769.5			
f. Other				103.0
5. Total Non-Federal Environmental Liabilities:	$ 40,366.2	$16,032.1	$ 7,387.3	$ 581.6

Others Category Disclosure Comparative Table

Types	September 30, 2004 (in millions)
Other Accrued Environmental Costs (Non-DERP funds)	
Defense Commissary Agency	**$ 9.2**
Base Realignment and Closure	
Army's prior BRAC unliquidated obligations that cannot be identified to a specific program	**$ 209.3**
Environmental Disposal for Weapons Systems Programs-Other	
DoD Component Level Accounts National Defense Stockpile - ODO	**$ 103.0**

The Department of Defense (DoD) is required to clean up contamination resulting from past waste disposal practices, leaks, spills and other past activity, which have created a public health or environmental risk. The department accomplishes this effort in coordination with regulatory agencies, and if applicable, with other responsible parties, and current property owners. The Department is also required to recognize closure and post-closure costs for its General Property, Plant, and Equipment (PP&E) and environmental corrective action costs for current operations. Each of the Department's major reporting entities is responsible for tracking and reporting all required environmental information related to environmental restoration costs, other accrued environmental costs, disposal costs of weapons systems, and environmental costs related to the base realignment and closures (BRAC) actions that have taken place in prior years.

The Department is currently using two independently validated estimating models in addition to engineering estimates. Validation of the models was performed in accordance with DoD Instruction 5000.61. The models are the Remedial Action Cost Engineering Requirements (RACER) model and the Department of Navy Cost-to-Complete (CTC) module of the Navy Normalization of Data System (NORM). Additionally, cost estimates are based on the following: (1) historic comparable project, (2) a specific bid or independent government cost estimate for the project, (3) site level data, and (4) annual cost-to-complete estimate. The cost-to-complete estimate is prepared in the Defense Environmental Restoration Program (DERP).

The DoD has clean up requirements for the DERP sites at active and BRAC installations and formerly used defense sites (FUDS), non-DERP at active installations, weapon systems programs, and chemical weapons disposal programs. The DoD follows the Comprehensive Environmental Response, Compensation Liability Act (CERCLA) and the Superfund Amendment and Reauthorization Act (SARA) to clean up DERP-eligible contamination. Non-DERP eligible contamination cleanup is performed in accordance with the Resource Conservation and Recovery Act (RCRA). The Army is the DoD Executive Agent for cleaning up contamination at sites formerly used by DoD. The CERCLA and RCRA require DoD to clean up contamination in coordination with regulatory agencies, other responsible parties, and current property owners. Failure to comply with agreements and legal mandates can put DoD at risk of fines and penalties.

The Chemical Weapons Disposal Program is based on the FY 1986 National Defense Authorization Act (PL 99-145, as amended by subsequent acts) that directed the DoD to destroy the unitary chemical stockpile by April 29, 2004. The current guidelines for destruction are based on the Chemical Weapons Convention (CWC) treaty. The United

States ratified the treaty in April 1997 and, according to the terms outlined, the United States must destroy its declared stockpile of chemical weapons by April 2007. The Army, as Executive Agent within the DoD, provides policy, direction, and oversight for both the Chemical Stockpile Program and the Non-Stockpile Chemical Materiel Project. As such, the Army is responsible for the safe and economical disposal of the U.S. stockpile of lethal and incapacitating chemical warfare agents and munitions. The program objective is to destroy the U.S. stockpile of unitary chemical agents and munitions in accordance with the public law and the schedules approved by the Defense Acquisition Decision Memorandum dated September 26, 2001, and updated in the April 2003 Acquisition Program Baseline.

The clean up requirements for nuclear-powered aircraft carriers, submarines, and other nuclear ships are based on several significant laws, which affect the Department's conduct of environmental policy and regulations. The Atomic Energy Act of 1954, as amended, assures the proper management of source, special nuclear, and byproduct material. As in all cases with nuclear power, the Department coordinates actions with the Department of Energy. The Nuclear Waste Policy Act of 1982 required all owners and generators of high-level nuclear waste and spent nuclear fuel, to pay their respective shares of the full cost of the program. Finally, the Low Level Radioactive Waste Policy Amendments Act of 1986 provides for the safe and efficient management of low-level radioactive waste.

The estimated total clean up cost for the current operating period is assigned based on the amount of the current year appropriation and unliquidated obligations that will be expended within 12 months from the Balance Sheet date. The noncurrent clean up cost is the portion of the clean up cost that will be expended more than 12 months from the Balance Sheet date.

The DoD has not identified any unamortized portion of the estimated total clean up cost associated with General Property, Plant and Equipment (PP&E). The Department's Financial Management Regulation requires the unamortized clean up cost associated with PP&E to be recognized. The Department is working with the Military Departments to ensure the regulation is properly implemented.

The Department had changes in estimation resulting from overlooked or previously unknown contaminants, better site characterization with sampling, cost avoidance rerun, re-estimation based on different assumptions and/or escalation, and re-estimation of costs based on lessons learned. Regulatory related changes include addition of range rule/munitions requirements, additional or extended long-term monitoring requirements or 5 year reviews, no further action agreement with the regulator, and risk-based corrective action. Technology related changes include additional contamination level sampling, additional or extended remedial action operation, additional sites and incomplete site data, and technical solution changes.

The Active Installations – ER for Closed Ranges increased $3.3 billion (77 percent). The Department of Army reported an increase of $2.6 billion that resulted from additional site level data collected from the Army range inventory. The Department of Navy reported an increase of $241.7 million due to adding 10 new sites at Concord and Seal Beach, California, an estimate increase for Vieques, Puerto Rico, escalation of cost estimates, and cost growth in preliminary findings. The Department of Air Force also reported an increase of $506.7 million that resulted from the identification of 20 additional sites.

Active Installations – Environmental Closure Requirements increased $74.9 million (72 percent). The variance is primarily due to an increase of $45.8 million in the Department of Air Force, $15.0 million in DoD Component Level Accounts, and a $14.1 million increase in the Department of Army. The increase for the Department of Air Force is attributable to a change in the amortization calculation that is now amortizing amounts over the life of an asset rather than assessing the liability in the year of disposal. The increase for the DoD Component Level Accounts is attributable to a reclassification from Other Accrued Environmental Costs (Non-DERP funds) – Other to Active Installations Environmental Closure Requirements. The increase for the Department of the Army is attributable to receipt of an updated Environmental Program Requirements (EPR) report with improved cost estimates and site changes, as well as the addition of previously omitted Class Zero estimates.

Other Accrued Environmental Costs (Non-DERP funds) - Other decreased $40.8 million (81 percent). A decrease of $35 million is attributable to a reclassification from Non-DERP Other to Active Installations-Environmental Restoration and Active Installations-Environmental Closure Requirements within a DoD Component Level

Account: An additional decrease of $1.5 million is also attributable to a reclassification from Non-DERP Other to Active Installations- Environmental Corrective Action within the Defense Threat Reduction Agency (DTRA). The remaining decrease of $4.4 million for the Defense Commissary Agency (DeCA) Surcharge entity is the result of a revised estimate used to calculate the noncurrent environmental clean up costs.

The BRAC Installations – Environmental Restoration (ER) decreased $495.7 million (14 percent). The decrease is primarily due to a $78.6 million increase reported by the Department of Army and a $529.4 million decrease reported by the Department of Air Force. The increase reported by the Department of the Army is due to the increased remediation efforts required. The decrease reported by the Department of Air Force resulted from implementation of a new cost estimating and reporting policy that limits the liability to 25 years of remediation action operations along with five years of long term monitoring.

The BRAC Installations – Environmental Corrective Action liability decreased $20.1 million (11 percent). The variance is primarily due to a decrease of $23.1 million reported by the Department of Army. This decrease reflects changes in cleanup actions required at a site.

Base Realignment and Closure (BRAC) – Other increased $18.9 million (10 percent). The variance is attributable to the Department of Army and reflects additional estimates previously omitted.

Note 15. Other Liabilities

As of September 30	2004 Current Liability	2004 Noncurrent Liability	2004 Total	2003 Total
1. Intragovernmental:				
A. Advances from Others	$ 749.6	$ 0.0	$ 749.6	$ 272.5
B. Deposit Funds and Suspense Account Liabilities	561.6	0.0	561.6	372.3
C. Disbursing Officer Cash	2,071.8	0.0	2,071.8	1,509.4
D. Accounts Payable-- Cancelled Appropriations	0.0	0.0	0.0	7.0
E. Judgement Fund Liabilities	278.1	101.7	379.8	591.4
F. FECA Reimbursement to the Department of Labor	600.5	831.7	1,432.2	1,420.8
G. Other Liabilities	3,794.8	1,737.1	5,531.9	5,565.7
H. Total Intragovernmental Other Liabilities	$ 8,056.4	$ 2,670.5	$ 10,726.9	$ 9,739.1

As of September 30	2004 Current Liability	2004 Noncurrent Liability	2004 Total	2003 Total
2. Non-Federal:				
A. Accrued Funded Payroll and Benefits	$ 9,581.2	$ 1,290.6	$ 10,871.8	$ 9,118.0
B. Advances from Others	1,741.4	0.2	1,741.6	1,167.3
C. Deferred Credits	4.2	0.0	4.2	9.7
D. Deposit Funds and Suspense Accounts	322.6	0.0	322.6	105.3
E. Temporary Early Retirement Authority	1.0	1.1	2.1	8.5
F. Nonenvironmental Disposal Liabilities:				
(1) National Defense PP&E (Nonnuclear)	0.0	565.8	565.8	574.9
(2) Excess/Obsolete Structures	84.0	351.3	435.3	394.9
(3) Conventional Munitions Disposal	0.0	1,325.9	1,325.9	1,198.8
(4) Other	0.0	0.0	0.0	0.0
G. Accounts Payable Cancelled Appropriations	0.0	0.0	0.0	602.3
H. Accrued Unfunded Annual Leave	7,991.5	0.0	7,991.5	7,645.3
I. Capital Lease Liability	50.5	249.4	299.9	336.4
J. Other Liabilities	9,365.2	1,565.3	10,930.5	8,992.6
K. Total Non-Federal Other Liabilities	$ 29,141.6	$ 5,349.6	$ 34,491.2	$ 30,154.0
3. Total Other Liabilities:	$ 37,198.0	$ 8,020.1	$ 45,218.1	$ 39,893.1

Fluctuations - Federal

Intragovernmental Other Liabilities Fluctuation Analysis

Intragovernmental Other Liabilities increased $987.8 million (10 percent). The following items contributed to the majority of the overall change:

Advances from Others (Line 1.A.)
Advances from Others increased $477.1 million (175 percent). The Air Force General Fund (GF) increased $478.3 million and is the principal reason for the overall increase. The Air Force increase is due to the timing of the receipt and execution of orders in the Research, Test, Development, and Evaluation (RDT&E) classified program, causing variations in the year-end balances.

Deposit Funds and Suspense Account Liabilities (Line 1.B.)

Deposit Funds and Suspense Account Liabilities increased $189.3 million (51 percent). The following items contributed to the majority of the overall change:

- Navy GF increased $33.6 million. The increase is due to the reclassification of unsupported undistributed collections from accounts payable to other liabilities.
- Army GF increased $69.9 million. The majority is attributable to an increase in the miscellaneous suspense and deposit funds for the following reasons:
  - Increase in Army Member Savings Deposits as a result of an increase in deployed soldiers who are drawing imminent danger pay. The soldiers are authorized to deposit funds and later withdraw the funds with interest.
  - Withheld State Income Taxes
  - Small Escrow Accounts due to the increase of soldiers using the post office and the Army Air Force Exchange Service in Kuwait and Iraq.
- Other Defense Organizations (ODO) GF increased $98.5 million. The increase occurred in the following activities:
  - Thrift Savings Plan Clearing Account: Increase of $43.1 million is related to normal business practices. The government acts in a fiduciary capacity by collecting money from civilian pay, providing matching funds, and disbursing the funds to the plan administrator. The balance in this account is predicated on collections (i.e., the amount of employee participation in a given pay period).
  - Small Escrow Deposit Fund: Increase of $55.4 million is related to normal business practices of the Defense Reutilization Management Office (DRMO). The DRMO is responsible for the disposition of government property. Any remuneration is deposited in the Small Escrow Deposit Fund until transferred to the appropriate organization.

Disbursing Officer Cash (Line 1.C)

Disbursing Officer Cash increased $562.4 million (37 percent). The following items contributed to the majority of the overall change:

- Army GF increased $573.0 million to support Operation Iraqi Freedom and Operation Enduring Freedom.
- Air Force GF increased $37.8 million. The increase is to support Operation Iraqi Freedom.
- Navy GF decreased $48.1 million. The decrease is the result of the Navy drawdown from Operation Iraqi Freedom and subsequent events. The expansion of the ATM at Sea and Navy Cash programs in FY 2004 also contributed to the decrease of Disbursing Officer Cash because Disbursing Officers do not need as much cash on hand.

Accounts Payable - Cancelled Appropriations (Line 1. D)

ODO GF decreased $7.0 million. During FY 2003, Missile Defense Agency's cancelled year unearned revenue was reclassified to accounts payables.

Judgment Fund Liabilities (Line 1.E.)

Judgment Fund Liabilities decreased $211.6 million (36 percent). The majority of the decrease is due to the settlement of claims in litigation as follows:

- Air Force GF decreased $150.3 million because the Air Force reimbursed the Treasury for amounts paid on their behalf.
- Army GF decreased $61.3 million and is based on judgment fund liabilities guidance for the Notification and Federal Employment Antidiscrimination and Retention Act of 2002.
- Navy GF decreased $7.3 million due to aggressive efforts to identify outstanding judgments.

Fluctuations - Non-Federal

Total Non-Federal Fluctuation Analysis

Non-Federal Other Liabilities increased $4.3 billion (14 percent). The following items contributed to the majority of the overall change:

Accrued Funded Payroll and Benefits (Line 2. A.)

Accrued Funded Payroll and Benefits increased $1.8 billion (19 percent). The following items contributed to the majority of the overall change:

- ODO GF increased $1.3 billion. The majority of the change is associated with the increase of "Incurred but not Reported Liability" for the Defense Health Program (DHP). This amount is an estimated liability for medical claims incurred by the DHP, but not reported. The DoD Office of the Actuary developed this estimate based on historical data showing medical claims by incurred date and paid date. This estimate also included factors such as administrative costs associated with the incurred but not reported claims, medical inflation, and the rate of beneficiary utilization of medical services.
- Air Force GF increased $299.6 million. The change is attributable to the increase in the number of military personnel activated in support of the war.

Advances from Others (Line 2.B.)

Advances from Others increased $574.3 million (49 percent). The following items contributed to the majority of the overall change:

- Army GF increased $160.5 million. The increase is due to military construction in South Korea. The U.S.Army Corps of Engineers (USACE) Pacific Ocean Division received these advances that are for various construction projects.
- Navy Working Capital Fund (WCF) increased $282.6 million. The increase is primarily attributable to a reclassification in the component business area in order to adjust for trading partner differences.
- USACE increased $28.9 million. The increase is due to an increase in customer orders from the public. A large percent of the increase in customer orders occurred in the New York and Honolulu districts. The New York district received an advance for the assessment of security of New York City's public water supply and the Honolulu district received advances for a variety of local projects.

Deferred Credits (Line 2.C.)

Deferred Credits decreased $5.5 million (57 percent). The decrease is attributable to the National Defense Stockpile Trust Fund. Deferred credits represent customer payments received for materials that have not yet been shipped. During FY 2004, customers required accelerated deliveries, which resulted in a reduction of deferred credits.

Deposit Funds and Suspense Accounts (Line 2.D.)

Deposit Funds and Suspense Accounts increased $217.3 million (206 percent). The majority of the increase is attributed to the reclassification of unsupported undistributed collections to deposit funds and suspense accounts.

Temporary Early Retirement Authority (Line 2.E.)

Temporary Early Retirement Authority decreased $6.4 million (75 percent). The following items contributed to the majority of the overall change:

- Air Force GF decreased $3.6 million. The decrease is due to the termination of the program.
- Army GF decreased $.3 million. The decrease is due to the termination of the program.
- Navy GF decreased $2.2 million.

Nonenvironmental Disposal Liabilities - Excess/Obsolete Structures (Line 2.F.2.)

Excess/Obsolete Structures increased $40.4 million (10 percent).

- Air Force GF increased $21.3 million. The increase is attributable to the recently completed housing market analysis that better defined the Air Force's surplus of inadequate housing inventory. Modifications in future year demolition strategy account for the change in disposal liability.
- Navy GF increased $19.0 million. The change is a result of additional buildings and facilities/utilities identified for disposal.

Nonenvironmental Disposal Liabilities - Conventional Munitions Disposal (Line 2.F.3.)

Conventional Munitions Disposal decreased $127.1 million (11 percent). The following items contributed to the majority of the overall change:

- Army GF increased $133.0 million due to a stockpile expansion of 7,258 tons.
- Air Force GF decreased $5.9 million. The decrease is due to a policy change during FY 2004 that transferred accounting responsibility for all disposal costs to the Department of the Army for inclusion in its financial statements. The Air Force no longer reports this activity.

Accounts Payable – Cancelled Appropriations (Line 2.G.)

Accounts Payable – Cancelled Appropriations decreased $602.3 million to $0. Cancelled accounts payable was correctly reported as part of other liabilities in FY 2003. Treasury mapping changes implemented in June 2004 required all entities to report cancelled accounts payable as part of accounts payable beginning in the 3rd Quarter of FY 2004.

Capital Lease Liability (Line 2.I)

Capital Lease Liability decreased $36.5 million (11 percent). The following items contributed to the majority of the overall change:

- Air Force GF decreased $28.2 million. The change is the result of a decrease in leases held by the Air Force in FY 2004.
- Army GF decreased $11.7 million. The change is a result of normal payments made against the lease liability.
- ODO GF increased $3.3 million. The change is a result of the increase in leased equipment.

Other Liabilities (Line 2.J.)

Other Liabilities increased $1.9 billion (22 percent). The following items contributed to the majority of the overall change:

- Navy WCF increased $1.1 billion. The majority of the change is due to the reclassification of an abnormal balance and an increase in depot level reparable carcass returns.
- ODO GF increased $1.6 billion. The majority of the change occurred in the Foreign Military Sales (FMS) Trust Fund due to a change in the net custodial cash balance. The custodial liability represents net collections received from the foreign customers less the funds disbursed on their behalf.
- Army GF decreased $712.7 million. The majority of the decrease was attributable to a NATO program, which Army incorrectly reported in FY 2003. For FY 2004, the Other Defense Organizations correctly reported this liability, which resulted in a decrease for Army GF.
- Air Force WCF decreased $278.7 million. The decrease is primarily attributable to the Depot Maintenance Activity Group (DMAG). The phase-out of contracts in the DMAG has resulted in a decline in material, labor, and overhead accruals.

Other Disclosures

In FY 2004 the DoD made a prior period adjustment to reclassify $1.0 billion of undistributed disbursements from other liabilities to cumulative results of operations. See Note 20 for further information.

Intragovernmental Other Liabilities by Entity

Intragovernmental Other Liabilities (Line 1.K) for 4th Quarter, FY 2004 ($millions)			
Entity	Current Liability	Non Current Liability	Total Liability
AF GF	317.6		317.6
AF WCF	8.6		8.6
Army GF	276.8		276.8
Army WCF	6.6		6.6
MRF		0.9	0.9
Navy GF	2,885.0		2,885.0
Navy WCF	42.6		42.6
ODO GF	112.9	10.3	123.2
ODO WCF	20.9		20.9
USACE	123.8	1,725.9	1,849.7
Total	3,794.8	1,737.1	5,531.9

Non-Federal Other Liabilities by Entity

Non-Federal Other Liabilities (Line 2.M.) for 4th Quarter, FY 2004 ($millions)			
Entity	Current Liability	Non Current Liability	Total Liability
AF GF	0.9	308.8	309.7
AF WCF	1,446.5		1,446.5
Army GF	1,051.6	742.2	1,793.8
Army WCF	42.5		42.5
MRF	0.2		0.2

Navy GF	150.6	81.4	232.0
Navy WCF	4,113.7	0.0	4,113.7
ODO GF	2,238.5	429.2	2,667.7
ODO WCF	181.5	3.7	185.2
USACE	139.2		139.2
Total	9,365.2	1,565.3	10,930.5

Capital Lease Liability

As of September 30 (Amounts in millions)	2004				2003
	Asset Category				
	Land and Buildings	Equipment	Other	Total	Total
1. Future Payments Due:					
A. 2004	$ 66.2	$ 0.2	$ 0.0	$ 66.4	$ 67.4
B. 2005	65.9	0.1	0.0	66.0	66.4
C. 2006	60.1	1.0	0.0	61.1	66.1
D. 2007	47.5	3.5	0.0	51.0	60.2
E. 2008	43.9	0.0	0.0	43.9	47.5
F. After 5 Years	129.3	0.0	0.0	129.3	184.4
G. Total Future Lease Payments Due	$ 412.9	$ 4.8	$ 0.0	$ 417.7	$ 492.0
H. Less: Imputed Interest Executory Costs	117.8	0.0	0.0	117.8	155.6
I. Net Capital Lease Liability	$ 295.1	$ 4.8	$ 0.0	$ 299.9	$ 336.4
2. Capital Lease Liabilities Covered by Budgetary Resources:				$ 219.4	$ 326.1
3. Capital Lease Liabilities Not Covered by Budgetary Resources:				$ 80.5	$ 127.2

Comparison of Capital Leases between Year-end FY 2003 and FY 2004 ($ amounts in millions)				
Future Payments Due	**YE 2004**	**YE 2003**	**Increase/ Decrease**	**% Change**
A. 2004	66.4	67.4	(1.0)	1.5
B. 2005	66.0	66.4	(0.4)	0.6
C. 2006	61.1	66.1	(5.0)	7.6
D. 2007	51.0	60.2	(9.2)	15.3
E. 2008	43.9	47.5	(3.6)	7.6
F. After 5 Years	129.3	184.3	(55.0)	29.8
G. Total Future Lease Payments Due	417.8	492.0	(74.2)	15.1
H. Less Imputed Interest Executory Costs	117.9	155.6	(37.7)	24.2
I. Net Capital Lease Liability	299.8	336.4	(36.6)	10.9
Capital Lease Liability Covered by Budgetary Resources	219.4	326.1	(106.7)	32.7
Capital Lease Liability Not Covered by Budgetary Resources	80.5	127.2	(46.7)	36.7

For the Department of Defense, all leases prior to FY 1992 are funded on an annual basis and subject to the availability of funds. Non-current amounts for these leases are shown as Not Covered by Budgetary Resources.

Leases originating after FY 1992 are required to be fully funded in the year of their inception. Therefore, budgetary resources show the present value of those lease payments as "covered."

Additional copy of Balance Sheet for students to tear out of Student Guides to follow in class.

Department of Defense
Agency Wide
CONSOLIDATED BALANCE SHEET
As of September 30, 2004 and 2003
($ in Millions)

		2004 Consolidated		2003 Consolidated Restated
ASSETS (Note 2)				
Intragovernmental:				
Fund Balance with Treasury (Note 3)				
Entity	$	287,685.5	$	251,544.1
Non-Entity Seized Iraqi Cash		113.4		278.1
Non-Entity-Other		1,800.0		239.8
Investments (Note 4)		231,069.7		205,376.0
Accounts Receivable (Note 5)		1,118.3		1,066.6
Other Assets (Note 6)		1,011.9		105.0
Total Intragovernmental Assets	$	522,798.8	$	458,609.6
Cash and Other Monetary Assets (Note 7)	$	2,178.1	$	1,534.9
Accounts Receivable (Note 5)		7,427.8		7,299.9
Loans Receivable (Note 8)		70.7		64.0
Inventory and Related Property (Note 9)		213,219.4		205,544.6
General Property, Plant and Equipment (Note 10)		440,898.6		446,308.9
Investments (Note 4)		406.5		217.8
Other Assets (Note 6)		21,486.3		21,729.6
TOTAL ASSETS	$	1,208,486.2	$	1,141,309.3
LIABILITIES (Note 11)				
Intragovernmental:				
Accounts Payable (Note 12)	$	1,888.4	$	101.4
Debt (Note 13)		591.8		698.2
Environmental Liabilities (Note 14)		0.0		0.0
Other Liabilities (Note 15 & Note 16)		10,726.9		9,739.1
Total Intragovernmental Liabilities	$	13,207.1	$	10,538.7
Accounts Payable (Note 12)	$	28,309.0	$	27,863.8
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 17)		1,569,704.7		1,429,565.5
Environmental Liabilities (Note 14)		64,367.2		61,490.6
Loan Guarantee Liability (Note 8)		34.4		25.9
Other Liabilities (Note 15 and Note 16)		34,491.2		30,154.0
Debt Held by Public		0.0		0.0
TOTAL LIABILITIES	$	1,710,113.6	$	1,559,638.5
NET POSITION				
Unexpended Appropriations (Note 18)	$	243,813.9	$	218,869.5
Cumulative Results of Operations		(745,441.3)		(637,198.7)
TOTAL NET POSITION	$	(501,627.4)	$	(418,329.2)
TOTAL LIABILITIES AND NET POSITION	$	1,208,486.2	$	1,141,309.3

Additional copy of Note 14 for students to tear out of Student Guides to follow in class.

Note 14.	**Environmental Liabilities and Disposal Liabilities**			
As of September 30	2004			2003
	Current Liability	Noncurrent Liability	Total	Total
(Amounts in millions)				
1. Environmental Liabilities – Non Federal				
A. Accrued Environmental Restoration (DERP funded) Costs:				
1. Active Installations--Environmental Restoration (ER)	$1,752.0	$9,116.2	$10,868.2	$11,833.8
2. Active Installations--ER for Closed Ranges	63.3	7,645.7	7,709.0	4,362.1
3. Formerly Used Defense Sites (FUDS) -- ER	341.0	3,980.3	4,321.3	4,239.4
4. FUDS--ER for Transferred Ranges	149.3	13,935.0	14,084.3	13,624.4
B. Other Accrued Environmental Costs (Non-DERP funds)				
1. Active Installations--Environmental Corrective Action	52.3	517.3	569.6	561.0
2. Active Installations--Environmental Closure Requirements	16.0	162.5	178.5	103.6
3. Active Installations--Environ. Response at Active Ranges	62.5	217.1	279.6	276.3
4. Other	0.4	8.8	9.2	50.0
C. Base Realignment and Closure (BRAC)				
1. BRAC Installations--Environmental Restoration (ER)	670.6	2,450.3	3,120.9	3,616.6
2. BRAC Installations--ER for Transferring Ranges	11.3	524.6	535.9	511.6
3. BRAC Installations--Environmental Corrective Action	15.3	152.5	167.8	187.9
4. Other	209.3	0.0	209.3	190.4

D. Environmental Disposal for Weapons Systems Programs				
1. Nuclear Powered Aircraft Carriers	0.0	5,693.0	5,693.0	5,565.0
2. Nuclear Powered Submarines	42.4	5,146.3	5,188.7	4,888.9
3. Other Nuclear Powered Ships	86.5	201.0	287.5	269.1
4. Other National Defense Weapons Systems	5.8	266.1	271.9	297.1
5. Chemical Weapons Disposal Program	1,096.9	9,672.6	10,769.5	10,810.3
6. Other	103.0	0.0	103.0	103.1
2. Total Environmental Liabilities:	$ 4,677.9	$ 59,689.3	$ 64,367.2	$ 61,490.6

Service Component – Environmental Restoration (Clean up) Liabilities and Environmental Disposal Liabilities (Amounts in millions)	Army	Navy	Air Force	ODO
1. Environmental Liabilities:				
A. Non-Federal:				
1. Accrued Environmental Restoration (Defense Environmental Restoration Program (DERP) funded) Costs:				
a. Active Installations-Environmental Restoration (ER)	$ 3,520.4	$ 2,841.5	$ 4,225.2	$ 281.1
b. Active Installations--ER for Closed Ranges	5,781.1	583.0	1,344.9	
c. Formerly Used Defense Sites (FUDS) –ER	4,321.3			
d. FUDS--ER for Transferred Ranges	14,084.3			
2. Other Accrued Environmental Costs (Non-DERP funds)				
a. Active Installations--Environmental Corrective Action	259.0		182.4	128.2
b. Active Installations--Environmental Closure Requirements	51.2		112.3	15.0
c. Active Installations--Environ. Response at Active Ranges	267.6			12.0
d. Other				9.2
3. Base Realignment and Closure (BRAC)				
a. BRAC Installations--Environmental Restoration (ER)	597.4	1,110.7	1,379.7	33.1
b. BRAC Installations--ER for Transferring Ranges	480.1	55.8		
c. BRAC Installations--Environmental Corrective Action	25.0		142.8	
d. Other	209.3			
4. Environmental Disposal for Weapon Systems Programs				
a. Nuclear Powered Aircraft Carriers		5,693.0		
b. Nuclear Powered Submarines		5,188.7		
c. Other Nuclear Powered Ships		287.5		
d. Other National Defense Weapon Systems		271.9		

		271.9		
e. Chemical Weapons Disposal Program	10,769.5			
f. Other				103.0
5. Total Non-Federal Environmental Liabilities:	$ 40,366.2	$16,032.1	$ 7,387.3	$ 581.6

Others Category Disclosure Comparative Table

Types	September 30, 2004 (in millions)
Other Accrued Environmental Costs (Non-DERP funds)	
Defense Commissary Agency	**$ 9.2**
Base Realignment and Closure	
Army's prior BRAC unliquidated obligations that cannot be identified to a specific program	**$ 209.3**
Environmental Disposal for Weapons Systems Programs-Other	
DoD Component Level Accounts National Defense Stockpile - ODO	**$ 103.0**

The Department of Defense (DoD) is required to clean up contamination resulting from past waste disposal practices, leaks, spills and other past activity, which have created a public health or environmental risk. The department accomplishes this effort in coordination with regulatory agencies, and if applicable, with other responsible parties, and current property owners. The Department is also required to recognize closure and post-closure costs for its General Property, Plant, and Equipment (PP&E) and environmental corrective action costs for current operations. Each of the Department's major reporting entities is responsible for tracking and reporting all required environmental information related to environmental restoration costs, other accrued environmental costs, disposal costs of weapons systems, and environmental costs related to the base realignment and closures (BRAC) actions that have taken place in prior years.

The Department is currently using two independently validated estimating models in addition to engineering estimates. Validation of the models was performed in accordance with DoD Instruction 5000.61. The models are the Remedial Action Cost Engineering Requirements (RACER) model and the Department of Navy Cost-to-Complete (CTC) module of the Navy Normalization of Data System (NORM). Additionally, cost estimates are based on the following: (1) historic comparable project, (2) a specific bid or independent government cost estimate for the project, (3) site level data, and (4) annual cost-to-complete estimate. The cost-to-complete estimate is prepared in the Defense Environmental Restoration Program (DERP).

The DoD has clean up requirements for the DERP sites at active and BRAC installations and formerly used defense sites (FUDS), non-DERP at active installations, weapon systems programs, and chemical weapons disposal programs. The DoD follows the Comprehensive Environmental Response, Compensation Liability Act (CERCLA) and the Superfund Amendment and Reauthorization Act (SARA) to clean up DERP-eligible contamination. Non-DERP eligible contamination cleanup is performed in accordance with the Resource Conservation and Recovery Act (RCRA). The Army is the DoD Executive Agent for cleaning up contamination at sites formerly used by DoD. The CERCLA and RCRA require DoD to clean up contamination in coordination with regulatory agencies, other responsible parties, and current property owners. Failure to comply with agreements and legal mandates can put DoD at risk of fines and penalties.

The Chemical Weapons Disposal Program is based on the FY 1986 National Defense Authorization Act (PL 99-145, as amended by subsequent acts) that directed the DoD to destroy the unitary chemical stockpile by April 29, 2004. The current guidelines for destruction are based on the Chemical Weapons Convention (CWC) treaty. The United

States ratified the treaty in April 1997 and, according to the terms outlined, the United States must destroy its declared stockpile of chemical weapons by April 2007. The Army, as Executive Agent within the DoD, provides policy, direction, and oversight for both the Chemical Stockpile Program and the Non-Stockpile Chemical Materiel Project. As such, the Army is responsible for the safe and economical disposal of the U.S. stockpile of lethal and incapacitating chemical warfare agents and munitions. The program objective is to destroy the U.S. stockpile of unitary chemical agents and munitions in accordance with the public law and the schedules approved by the Defense Acquisition Decision Memorandum dated September 26, 2001, and updated in the April 2003 Acquisition Program Baseline.

The clean up requirements for nuclear-powered aircraft carriers, submarines, and other nuclear ships are based on several significant laws, which affect the Department's conduct of environmental policy and regulations. The Atomic Energy Act of 1954, as amended, assures the proper management of source, special nuclear, and byproduct material. As in all cases with nuclear power, the Department coordinates actions with the Department of Energy. The Nuclear Waste Policy Act of 1982 required all owners and generators of high-level nuclear waste and spent nuclear fuel, to pay their respective shares of the full cost of the program. Finally, the Low Level Radioactive Waste Policy Amendments Act of 1986 provides for the safe and efficient management of low-level radioactive waste.

The estimated total clean up cost for the current operating period is assigned based on the amount of the current year appropriation and unliquidated obligations that will be expended within 12 months from the Balance Sheet date. The noncurrent clean up cost is the portion of the clean up cost that will be expended more than 12 months from the Balance Sheet date.

The DoD has not identified any unamortized portion of the estimated total clean up cost associated with General Property, Plant and Equipment (PP&E). The Department's Financial Management Regulation requires the unamortized clean up cost associated with PP&E to be recognized. The Department is working with the Military Departments to ensure the regulation is properly implemented.

The Department had changes in estimation resulting from overlooked or previously unknown contaminants, better site characterization with sampling, cost avoidance rerun, re-estimation based on different assumptions and/or escalation, and re-estimation of costs based on lessons learned. Regulatory related changes include addition of range rule/munitions requirements, additional or extended long-term monitoring requirements or 5 year reviews, no further action agreement with the regulator, and risk-based corrective action. Technology related changes include additional contamination level sampling, additional or extended remedial action operation, additional sites and incomplete site data, and technical solution changes.

The Active Installations – ER for Closed Ranges increased $3.3 billion (77 percent). The Department of Army reported an increase of $2.6 billion that resulted from additional site level data collected from the Army range inventory. The Department of Navy reported an increase of $241.7 million due to adding 10 new sites at Concord and Seal Beach, California, an estimate increase for Vieques, Puerto Rico, escalation of cost estimates, and cost growth in preliminary findings. The Department of Air Force also reported an increase of $506.7 million that resulted from the identification of 20 additional sites.

Active Installations – Environmental Closure Requirements increased $74.9 million (72 percent). The variance is primarily due to an increase of $45.8 million in the Department of Air Force, $15.0 million in DoD Component Level Accounts, and a $14.1 million increase in the Department of Army. The increase for the Department of Air Force is attributable to a change in the amortization calculation that is now amortizing amounts over the life of an asset rather than assessing the liability in the year of disposal. The increase for the DoD Component Level Accounts is attributable to a reclassification from Other Accrued Environmental Costs (Non-DERP funds) – Other to Active Installations Environmental Closure Requirements. The increase for the Department of the Army is attributable to receipt of an updated Environmental Program Requirements (EPR) report with improved cost estimates and site changes, as well as the addition of previously omitted Class Zero estimates.

Other Accrued Environmental Costs (Non-DERP funds) - Other decreased $40.8 million (81 percent). A decrease of $35 million is attributable to a reclassification from Non-DERP Other to Active Installations-Environmental Restoration and Active Installations-Environmental Closure Requirements within a DoD Component Level

Account: An additional decrease of $1.5 million is also attributable to a reclassification from Non-DERP Other to Active Installations- Environmental Corrective Action within the Defense Threat Reduction Agency (DTRA). The remaining decrease of $4.4 million for the Defense Commissary Agency (DeCA) Surcharge entity is the result of a revised estimate used to calculate the noncurrent environmental clean up costs.

The BRAC Installations – Environmental Restoration (ER) decreased $495.7 million (14 percent). The decrease is primarily due to a $78.6 million increase reported by the Department of Army and a $529.4 million decrease reported by the Department of Air Force. The increase reported by the Department of the Army is due to the increased remediation efforts required. The decrease reported by the Department of Air Force resulted from implementation of a new cost estimating and reporting policy that limits the liability to 25 years of remediation action operations along with five years of long term monitoring.

The BRAC Installations – Environmental Corrective Action liability decreased $20.1 million (11 percent). The variance is primarily due to a decrease of $23.1 million reported by the Department of Army. This decrease reflects changes in cleanup actions required at a site.

Base Realignment and Closure (BRAC) – Other increased $18.9 million (10 percent). The variance is attributable to the Department of Army and reflects additional estimates previously omitted.

Appendix C. Draft Cycle Memo

This appendix contains an example cycle memorandum provided by the Navy that follows the events to record environmental liabilities on the Department of Navy annual financial statements.

DON General Fund Environmental Liabilities – DERP & BRAC	
Entities Responsible for DON General Fund Environmental Liabilities Business Process: • **Defense Finance and Accounting Service – Cleveland (DFAS-CL)** *1240 East 9th St.* *Cleveland, OH 44199;* • **Naval Facilities Engineering Command (NAVFAC)** *1322 Patterson Ave SE Ste 1000* *Washington Navy Yard, DC 20374; and* • **Department of the Navy – Office of Financial Operations (FMO)** *720 Kennon St. SE, Bldg 36* *Washington Navy Yard, DC 20374*	**Points of Contact:** • Dave Tomcho, DFAS-CL, 216-204-2742, dave.tomcho@dfas.mil; • Martha Midgette, NAVFAC, 202-685-9328, martha.midgette@navy.mil; and • Regina Lau, FMO, 202-685-6706, regina.lau@navy.mil • Beth Schulz, FMO, 202-685-9398, beth.schulz@navy.mil
Purpose: To record environmental liabilities on the DON Annual Financial Statements.	
Prepared By: FMO	**Point of Contact:** Shandell Hart, 202-685-6758

Defense Environmental Restoration Program (DERP)

DERP Manual (http://www.dtic.mil/envirodod/policies/PDDERP.htm)
NERP Manual (http://portal.specialtechnology.net/sites/NERP)

Process Description:

The 1990 Chief Financial Officers (CFO) Act added new requirements for the DON to report liabilities, including environmental liabilities. Environmental liabilities are defined as projected future costs to remove, contain, and/or dispose of hazardous waste or hazardous waste-laden material and/or property. Within the environmental arena, liabilities are divided into the environmental restoration and environmental disposal categories. Environmental Restoration are studies, cleanup, and other actions taken to address contamination from past DoD activities to protect human health and the environment. Environmental disposal liabilities are liabilities associated with the disposition of property, structures, equipment, and munitions.

The DON Environmental Liabilities line item is divided into four classes: Accrued Environmental Restoration (Defense Environmental Restoration Program (DERP) funded) Costs, Other Accrued Environmental Costs (Non-DERP funds), Base Realignment and Closure (BRAC), Environmental Disposal for Weapons Systems Programs.

Accrued Environmental Restoration (DERP Funded). In 1986, Congress amended the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) to create DERP and its budgetary funding mechanism, the Defense Environmental Restoration Account (DERA). DERP addresses environmental restoration at over 30,000 sites at active and closing military installations, as well as Formerly Used Defense Sites (FUDS), across the nation and the U.S. territories.

To address the different kinds of contaminants likely to impact DoD installation and former properties, the Department organized DERP into three program categories: Installation Restoration Program (IRP), Military Munitions Response Program (MMRP), and Building Demolition/Debris Removal (BD/DR). Under these program categories, DoD addresses contamination at three types of property: active installations, BRAC installations, and leased or operated FUDS.

Base Realignment and Closure (BRAC) is designed to eliminate excess military infrastructure and further streamline/modernize DoD's infrastructure. BRAC includes environmental restoration activities at closing and realigning installations and funded by the DoD Component BRAC accounts. This program is analogous to the DERP and funds the same activities that are eligible under the DERP. It does not include building demolition and debris removal or ordnance and explosive waste activities. In addition, it does not include closure-related environmental compliance requirements.

NAVFAC HQ approves all new sites. Though new site information and cost estimate can be manually entered into NORM, the CTC estimate is not considered an environmental liability until the site is approved and approval code is entered in FIS.

Recordation:

Site Establishment – Beth Schulz

1. Facility (site) requiring environmental restoration is identified by Remedial Project Manager (RPM).
2. Field Activity RPM completes DSERTS form to "Add New Site". The form is electronically sent to NAVFAC HQ for review and approval. *See Tab 3 Attachment 1*
3. Field Activity records new site information into Facilities Information System (FIS) with pending activity approval code.
4. FIS data trickles down into NORM.
5. If not an existing site, Remedial Project Manager (RPM) sends request to NAVFAC stating nature of problem and specific information, requesting new site approval.
6. If problem is approved by HQ Site Manager as "site", a DERP/BRAC cost

estimate is established in NORM. HQ Site Manager changes "pending" code to "approved" code in FIS.

7. NAVFAC HQ runs a batch process from FIS to load approved sites in NORM on fields in the Site Editor module. FIS batch module is downloaded by NAVFAC HQ (Site Manager).
8. RPM creates or updates cost estimate package for the site, thus establishing the environmental liability, using government estimate or V, V&A, in NORM/RACER.

Budgeting

9. Estimates are reviewed by field supervisor and NAVFAC Headquarters (HQ). The numbers are used during budget preparation.
10. RPM makes changes, if required, and archives cost estimate documentation in NORM.
11. Field supervisor completes initial Quality Assurance (QA) and Quality Control (QC) and submits budget to HQ.
12. HQ performs final QA/QC.
13. Final government estimate is completed during year of actual project execution to ensure cost estimates are up-to-date and as accurate as possible.
14. HQ reconciles any differences between BRAC & ER,N budget tables in NORM, NORM costs, and complete estimates. *(See Samples at Tab 3.A.1 WP 9/18, 10/18)*
15. HQ determines which data set (DFAS, FIS, or Budget Tables) is most recent and best fit to estimate ULO and future liabilities.
16. HQ updates spreadsheet with clean financial data for current reporting period and uploads data into DCI.

Quarterly Recording & Reporting

17. FMO creates summarized DCI data spreadsheet with DERP & BRAC information.
18. FMO submits data call information with DERP & BRAC data to DFAS-CL via email.
19. RA receives email from FMO with notification that DCI is ready.
20. RA accesses DCI website and downloads DERP/BRAC DCI Report. *(See Sample at Tab 3.A.1 WP 7/18-8/18)*
21. RA pulls DERP/BRAC JV Worksheet from shared drive.
22. RA updates DERP/BRAC JV Worksheet with ending balance data from DERP/BRAC DCI Report.
23. RA prepares JV to record DERP & BRAC. *(See Samples at Tab 3.A.1 WP 2/18 , 3/18, 5/18, & 6/18)*

24. RA forwards JV Approval Package to Branch Chief.
25. RA receives the reviewed JV Approval Package and determines if JV is approved or requires correction.
26. If approved, DFAS-CL records JV in DDRS.

1. **Financial Reporting Control Objective:** Facility data should be entered into the system correctly.

   Risk of potential misstatement: Field Analyst inputs incorrect facility data into the system.

   Control Activity: Remedial Project Manager validates facility data prior to its input into the Financial Information System (FIS), and ultimately NORM. In addition this informatio n is also reviewed and approved by NAVFAQ HQ – see # 3 above.

2. **Financial Reporting Control Objective:** RPM creates an accurate cost estimate using government estimate or V, V&A, in NORM/RACER.

   Risk of potential misstatement: RPM creates an inaccurate cost estimate using government estimate or V, V&A, in NORM/RACER.

   Control Activity: Estimates are reviewed by field supervisor and at NAVFAC Headquarters (HQ) and used during budget preparation – see # 5 above.

3. **Financial Reporting Control Objective:** Field supervisor provides a complete QA/QC and submits budget to HQ.

   Risk of potential misstatement: Field supervisor provides an incomplete QA/QC and submits budget to HQ.

   Control Activity: HQ performs a final QA/QC reconciling any differences between BRAC & ER, N budget tables in NORM, NORM costs, and complete estimates– see # 10 above.

4. **Financial Reporting Control Objective:** FMO submits data call information with a correct summary of DERP & BRAC data.

   Risk of potential misstatement: FMO creates data spreadsheet with inaccurate DERP & BRAC information.

   Control Activity: FMO designees review summarized DCI data spreadsheet prior to submitting data call info via email to RA. – see # 16 above.

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Appendix D. Draft of Accounting Entries

This appendix contains the draft DoDFMR, Volume 4, Chapter 13 accounting entries for the Estimated Cleanup Cost Liability (USSGL 2995) provided by the OSD Comptroller's office.

Table 13-1
ACCOUNTING ENTRIES FOR ACCOUNT USSGL 2995-
ESTIMATED CLEANUP COST LIABILITY

1. Dr 6800 Future Funded Expenses
   Cr 2995 Estimated Cleanup Cost Liability

Record the current period liability for cost to be funded in the future. This entry is also applicable for the systematically recognized portions of environmental liabilities.

2. Dr 2995 Estimated Cleanup Cost Liability
   Dr 6100 Operating Expenses/Program Costs
   Cr 2110 Accounts Payable
   Cr 6800 Future Funded Expenses

And

Dr 4610 Allotments – Realized Resources
Dr 4801 Undelivered Orders – Obligations, Unpaid
Cr 4901 Delivered Orders – Obligations, Unpaid

And (if funded by a direct appropriation)

Dr 3107 Unexpended Appropriations – Used
Cr 5700 Expended Appropriations

Record previously estimated cleanup costs that are due and payable for receipt of goods or services that have not been paid.

3. Dr 2110 Accounts Payable
   Cr 1010 Fund Balance with Treasury

And

Dr 4901 Delivered Orders – Obligations, Unpaid
Cr 4902 Delivered Orders – Obligations, Paid

Record payment.

4. Dr 3310 Cumulative Results of Operations
   Cr 6800 Future Funded Expenses
   Cr 6100 Operating Expenses/Program Costs

To record the closing of the expense accounts to cumulative results of operations.

Table 13-2
ALTERNATIVE ACCOUNTING ENTRIES FOR USSGL ACCOUNT 2995-ESTIMATED CLEANUP COST LIABILITY (PENDING SYSTEM MODERNIZATION)

1. Dr 6800 Future Funded Expenses
   Cr 2995 Estimated Cleanup Cost Liability

Record the current period liability for cost to be funded in the future. This entry is also applicable for the systematically recognized portions of environmental liabilities.

2. Dr 2995 Estimated Cleanup Cost Liability
   Cr 6800 Future Funded Expenses

Reverse accruals at the beginning of the next accounting period.

3. Dr 6800 Future Funded Expenses
   Cr 2995 Estimated Cleanup Cost Liability

Record the total current period revised estimated liability for cost to be funded in the future. This entry is also applicable for the systematically recognized portions of environmental liabilities.

4. Dr 6100 Operating Expenses/Program Costs
   Cr 2110 Accounts Payable

And

Dr 4610 Allotments – Realized Resources
Dr 4801 Undelivered Orders – Obligations, Unpaid
Cr 4901 Delivered Orders – Obligations, Unpaid
And (if funded by a direct appropriation)

Dr 3107 Unexpended Appropriations – Used
Cr 5700 Expended Appropriations

Record previously estimated cleanup costs that are due and payable for receipt of goods or services that have not been paid.

Table 13-2
ALTERNATIVE ACCOUNTING ENTRIES FOR USSGL ACCOUNT 2995-ESTIMATED CLEANUP COST LIABILITY (PENDING SYSTEM MODERNIZATION) (CONTINUED))

5. Dr 2110 Accounts Payable
 Cr 1010 Fund Balance with Treasury

And

Dr 4901 Delivered Orders – Obligations, Unpaid
 Cr 4902 Delivered Orders – Obligations, Paid

Record payment.

6. Dr 3310 Cumulative Results of Operations
 Cr 6800 Future Funded Expenses
 Cr 6100 Operating Expenses/Program Costs

To record the closing of the expense accounts to cumulative results of operations.

Appendix E. FAM Excerpts on Environmental Liabilities

This appendix contains excerpts from the GAO/PCIE FAM Section III, Balance Sheet, concerning environmental liabilities.

Section III
Balance Sheet

Liabilities **Other Liabilities (320 – 353)**	**Yes, No or N/A**	**Explanation**
344. Does the entity disclose the following related to commitments and contingencies? a. an estimate of obligations related to canceled appropriations for which the reporting entity has a contractual commitment for payment b. amounts for contractual arrangements that may require future financial obligations (OMB Bulletin 01-09, p. 27, section 3.4 & pp. 85 & 86, section 9.19)		
345. If material, does the entity separately recognize a contingent liability for environmental clean-up costs[53] for PP&E if the following criteria apply? a. they are related to a past transaction or event b. the related costs are probable and measurable (SFFAS 5, par. 38 & SFFAS 6, par. 91-93; OMB Bulletin 01-09, pp. 25 & 26, section 3.4)		
346. When clean-up costs are paid, are the payments recognized as a reduction in the liability for clean-up costs? (SFFAS 6, par. 100)		
347. If clean-up costs have not been previously recognized, is a liability recognized for the portion of the estimated total clean-up cost that is attributable to either the portion of the physical capacity used or the portion of the estimated useful life that has passed since the PP&E was placed into service? (SFFAS 6, par. 104-106)		
348. Are any subsequent changes (made in periods following implementation) in estimated total clean-up cost immediately expensed (if costs are to be recovered though user charges) and reflected in the related liability balance? (SFFAS 6, par. 104)		

[53] Clean-up costs are the costs of removing, containing, and/ or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E. (SFFAS 6, par. 85)

Section III
Balance Sheet

Liabilities **Other Liabilities (320 – 353)**	**Yes, No or N/A**	**Explanation**
349. When clean-up costs are recognized for the first time, is the offsetting charge for any liability for clean-up costs shown as a "prior-period adjustment?" (SFFAS 6, par. 105; SFFAS 21, par. 13)		
350. Are the amounts of prior-period adjustments arising from belated recognition of clean-up costs and liabilities disclosed and, if possible, are amounts associated with current and prior periods noted? (SFFAS 6, par. 105; SFFAS 21, par. 13)		
351. Does the entity also disclose the following information related to clean-up costs? a. the sources (i.e., applicable laws and regulations) of clean-up requirements b. the method for assigning estimated total clean-up costs to current operating periods (e.g., physical capacity versus passage of time) c. the unrecognized portion of estimated total clean-up costs associated with PP&E d. the material changes in total estimated clean-up costs due to changes in laws, technology, or plans e. the portion of change in an estimate that relates to prior-period operations f. the nature of estimates and the disclosure of information regarding possible changes due to inflation, deflation, technology, or applicable laws and regulations (SFFAS 6, par. 107-111; OMB Bulletin 01-09, p. 81, section 9.15)		

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Appendix F. Financial Improvement Initiative Business Rules

This appendix contains information on the Financial Improvement Initiative Business Rules. It includes an 18-step checklist that entities should use while preparing their assertion package, of which a sample is also included. Note that the term in this document “mid-range” was used when the Components were directed to have an unqualified audit opinion on FY 2007 Financial Statements. The approach has since been changed and is no longer date-driven, but based on a business case approach where the business devises the solution and determines how long it will take.

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

JUN 23 2004

COMPTROLLER

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE
DIRECTORS OF THE DEFENSE AGENCIES
COMMANDER, SPECIAL OPERATIONS COMMAND
COMMANDER, U.S. ARMY CORPS OF ENGINEERS

SUBJECT: Financial Improvement Initiative Business Rules

The Military Departments, Defense Agencies, and other primary fund-holders have prepared improvement plans to ensure the Department achieves an unqualified audit opinion on the fiscal year (FY) 2007, Department of Defense (DoD)-wide financial statements. To ensure a disciplined structure through the process, I have attached business rules to guide the Components and other primary fund holders, as well as the Inspector General, Department of Defense (IG, DoD).

You are required to comply with the following five phases in the attached business rules:

- Discovery and correction phase: Management identifies deficiencies and implements corrective actions.
- Validation phase: Management validates financial information after corrective actions are completed.
- Assertion phase: Management asserts to IG, DoD the reliability of the financial information.
- Assessment: IG, DoD does limited review of financial information to determine if it is ready for audit.
- Audit: IG, DoD audits the organization's financial statements that management asserted were ready for audit and that passed IG, DoD assessment.

By diligently following the attached business rules and closely monitoring your improvement plans, we can reach our goal of receiving an unqualified opinion on the DoD-wide financial statements in FY 2007. I appreciate everyone's hard work in achieving this goal.

My point of contact for these business rules is Mary Braun. She can be reached at (703) 693-6505 or by e-mail at mary.braun@osd.mil.

Lawrence J. Lanzillotta

Lawrence J. Lanzilotta
Acting

Attachments:
As stated

CHECKLIST

When performing corrective action validation and while perparing the assertion package, please complete the following checklist. Include the completed checklist as an attachment to your assertion letter.

This check list is designed to help components prepare for audits by providing the information that is typically needed for financial statement audits. Keep in mind that the list of specific items you will need for an assessment or audit will come from the auditors in the form of a "Prepared By Client (PBC) List."

The following steps may begin during the Discovery Phase or Correction Phase to assist those performing the assessment in validating that these steps have been completed.

☐ 1 Identify and document the procedures, processes, and control points for deriving the balance(s) being asserted. Include the systems that are used and the flow of data from field level to departmental level. This can be done in a cycle memorandum or flow chart format. Having this information prepared in advance will be a great tool for you to refer to during the assessment and audit. Also, the auditors will need to document the information so you will already have the information prepared. Be sure to identify all systems that have detail that makes up the balance(s) being asserted as ready for audit.

☐ 2 Have all General Ledger transaction detail and supporting information from feeder systems available for all the transactions that make up the balance(s) being asserted. Ensure the total of the detail equals the balance of the line item. This includes all accounting adjustments that have an effect on the ending balance of a line item reported on the financial statements.

☐ 3 Consolidate evidential matter that supports the transactions in step 2 or map where the evidential matter is located for easy and expedient retrieval.

☐ 4 Prepare a summary of the validation work performed by management Service auditors, internal auditors, or independent public accounting firms to establish audit readiness, if applicable.

☐ 5 Complete all the corrective actions in your Mid-Range Financial Improvement Plan for the material deficiencies related to the balance(s) being asserted.

☐ 6 Using the information from number 5 above, prepare an explanation of the actions taken to fix previously identified or existing problems and incorporate the explanation in the assertion letter or include as attachment to the letter. Be very specific.

☐ 7 Compile organization charts indicating key personnel and their responsibilities and phone lists.

8 For all the systems identified in step 1 above, has there been a Financial Information Security Audit Manual Controls (FISCAM) or Statement of Auditing Standard (SAS) 70/88 audit conducted on the systems?

☐ Yes If yes, provide the date and point of contact.

☐ No

Attachment 4

- [ ] 9 **For the Systems identified in step 1 that you answered Yes in step 8, obtain a copy of the FISCAM or SAS 70/88 audit report and skip the rest of the steps. For the systems identified in step 1 that you answered No in step 8, proceed to step 10.**

  If a FISCAM or SAS 70/88 audit has not been conducted on the system, then the auditors will have to perform alternate procedures on the system. Therefore, the following information will have to be gathered prior to the audit for each system.

- [ ] 10 Prepare a description of the major hardware and software of the system and interfaces with other systems
- [ ] 11 Describe what type of data the system produces for the financial statements, e.g. accounting transactions
- [ ] 12 Prepare a description of telecommunications devices and networks used with the system.
- [ ] 13 Obtain a copy of the most recent certifications and accreditations of the system.
- [ ] 14 Identify the system location(s) and end user locations.
- [ ] 15 Identify the location(s) of system documentation.
- [ ] 16 Identify the type, dollar value, and number of transactions processed in the system in a month and in a year.
- [ ] 17 Obtain a list of all system users - this should be a print out that shows the user and level of access.
- [ ] 18 Inquire if there are any ongoing or planned system reviews - if there are, determine when the reviews will be complete.

Attachment 4

SAMPLE MANAGEMENT ASSERTION

MEMORANDUM FOR INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE

SUBJECT: Management Assertion for (fill in line item/financial statement)

This memorandum is to inform the Inspector General of the Department of Defense that the (ie: Army General Fund) has completed corrective actions of the material deficiencies on the (ie: Accounts Receivable) line item on the (ie: balance sheet). (ie: Accounts Receivable) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We have also completed the attached checklist indicating our preparedness.

We completed the following actions to correct the known material deficiencies in this area:

(From step 6 of the attached checklist – using the corrective actions detail from your Mid-Range Financial Improvement Plans, list the specific corrective actions performed to fix all known deficiencies in this area. Be very specific. If the explanation is extensive, consider referring to an attachment for the detailed explanation)

We have sufficient audit-ready evidential matter to support the transactions that constitute the (ie: Accounts Receivable) balance shown on the (ie: balance sheet). The documentation can be provided to the auditors within a reasonable amount of time. We request that the auditors provide our field sites a data request list at least three weeks prior to arriving in the field.

We understand that significant accounting resources are required to support an audit. We have sufficient knowledgeable staff available to support audit requests during audit fieldwork. We request that the auditors alert us at least three weeks prior to visiting a field site, so we can adjust schedules to accommodate the anticipated workload to support the visiting auditors.

Signed by agency financial manager/CFO

cc: OUSD(C)

Attachment
As stated

Attachment 3

Financial Management Improvement Initiative
Assertion Process Business Rules

Introduction

Section 1008 of the "National Defense Authorization Act for Fiscal Year 2002" requires that the Under Secretary of Defense (Comptroller) (USD(C)) assess the reliability of the Department of Defense (DoD) financial statements, including the financial statements of each component of the Department. For those statements expected to be unreliable, the USD(C) is to minimize resources expended on financial statement preparation, consistent with the benefits to be derived and redirect resources to corrective actions. Entities that prepare financial statements will prepare preliminary representation letters regarding the reliability of their financial statements.

Section 1008 further requires that, for each financial statement asserted to be unreliable, the Office of the Inspector General of the Department of Defense (IG, DoD) shall only perform the audit procedures required by generally accepted government auditing standards, consistent with any representation made by management. Once a reporting entity represents that its financial statements are reliable, Section 1008 no longer applies to that entity, and the IG, DoD will perform a full financial statement audit of the entity.

The Business Rules provide the framework which DoD leadership should use to move their entities' financial statements from a position of unreliability to that of reliability and, ultimately, to an unqualified audit opinion.

Background

For purposes of identifying and meeting the requirements of the fund holders within the DoD, they have been grouped into four categories as follows:

- Tier 1: Entities directed by Office of Management and Budget to prepare audited financial statements and the Medicare Eligible Retiree Health Care Fund,
- Tier 2: Intelligence Agencies,
- Tier 3: Entities directed by the DoD to prepare stand-alone financial statements,
- Tier 4: All other DoD Agencies, entities, and funds. Although not required to prepare financial statements, Tier 4 entities should prepare improvement plans to ensure their trial balances are auditable.

Discovery and Correction Phase

The purpose of the Discovery Phase is to identify obstacles which would prevent the entity from obtaining an unqualified audit opinion and to prepare improvement plans with solutions that have measurable outcomes for overcoming those obstacles.

- Entities will prepare a financial improvement plan, in accordance with the appropriate USD(C) memoranda dated August 8, 2003, or September 18, 2003, for achieving an unqualified audit opinion of their financial statements.
- Entities will identify in their plans, by financial statement line item, all known deficiencies relating to the line item which cause an erroneous presentation of that line item. Deficiencies could include accounts requiring correction and processes

requiring improvement in order to achieve an unqualified audit opinion on the entity's financial statements. To prioritize corrective actions, entities should identify deficiencies that have a material impact on the financial statements in consultation with internal and external auditors.

- Entities will prepare comprehensive corrective action plans to resolve the identified deficiencies, identify measurable steps, with completion dates, to ensure each applicable item identified in the plans is addressed and resolved.
- Include in the corrective action plans any requirement for systems audits which would need to be performed so reliance can be placed on the systems when an audit is performed.
- If current systems must be modified and the modifications are part of the corrective actions, entities will prepare a business case to support the modification to be provided to the Business Modernization Management Program Office and advise the assigned USD(C) point of contact.

As part of the Discovery/Correction Phase, DoD entities should implement the solution sets, within the milestone dates prescribed, resulting in a resolution of the identified discrepancy. This phase is anticipated to be multi-faceted and incremental. All corrective action steps are not expected to be completed on the same date.

- Entities will aggressively pursue corrective actions identified in the improvement plans to resolve all known deficiencies by designated milestone dates.
- Management personnel and audit committees at each activity will closely monitor progress to ensure actions taken are to achieve the intended result in the time allotted.
- As corrections are ongoing, it is anticipated that new deficiencies may be identified. As this occurs, activities will coordinate with OUSD(C) points of contact to modify plans to include any such additions.
- Requests for extension of dates should include actions taken to date, reason for date slippage, new proposed completion date, and plan for getting back on track to meet the next original milestone date.

Validation Phase

The purpose of the Validation Stage is to validate that the corrective actions have effectively overcome previously identified deficiencies identified in the Discovery Stage and deficiencies identified during the Correction Phase and to determine if sufficient controls and transaction information are available to support management's assertion that the line or statement is ready for audit.

A validation is a limited scope evaluation or review to determine whether previously identified deficiencies in an entity's financial statement(s) or line have been satisfactorily remedied. This review is the responsibility of management and may be performed by management, internal auditors, or a contractor. The scope of specific procedures required for each validation are the responsibility of management and will be determined in the context of the materiality of each issue or action taken in that circumstance. This process is primarily for management to determine if their statement or line is ready for an assessment or audit by the IG, DoD. If management determines that the statement or line is ready for an assessment or audit, the work accomplished during the validation may be used by the IG, DoD. It is important

2 Attachment 2

that the IG, DoD be aware of the validation technique being performed by the entity prior to the initiation of the validation process to facilitate the assessment process after the entity submits its assertion package. The IG, DoD has no defined role in the conduct of a validation.

- At the beginning of the Validation Stage, entities will notify the IG, DoD by memorandum, with a copy furnished to OUSD(C) points of contact, of the entity's intent to validate a line or statement and the corrective actions taken to resolve deficiencies. The notification will include the intended method for validating that the corrective action did correct the known deficiency and that the line or statement is ready for audit. Although the IG, DoD has no specific role in the validation phase, the IG, DoD may, in an advisory capacity, comment on any obvious flaws or items of concern related to the validation methodology. The OUSD(C) points of contact will notify the Review and Prioritization Subcommittee (RPS). The RPS will notify the Executive Steering Committee (ESC) and, if any concerns exist, the ESC will provide a memorandum to the entity conveying its concerns.
- During the Validation Stage, the entity will perform a validation of the resolution of the identified deficiencies. Validation may be performed by Internal Review, Independent Public Auditors, or by internal management reviews. These validations are being performed at the request of and under the oversight of management. Audit committees should be actively engaged in overseeing the progress of the validation process.
- During the Validation Stage, management will complete the attached checklist (Attachment 4) in preparation for assertion. The checklist includes such steps as documenting processes, identifying controls, and preparing an auditable universe to be used during the assessment and audit phase. The checklist will be an attachment in management's assertion package.
- The validation process, in preparation for audit, will also ensure that supporting documentation is available for audit.

Assertion Phase

The purpose of the Assertion Phase is to notify the IG, DoD that validation of corrected deficiencies have been completed and that a financial statement or line item is ready for audit. During the Assertion Phase, management will prepare an assertion memorandum asserting audit readiness and a package of accompanying documentation to support the position of audit readiness.

- Entities will prepare an assertion package and submit it to IG, DoD, with copy furnished to the OUSD(C) point of contact who will forward it to the RPS.
- The assertion package will contain the following:
    - Management assertion letter, prepared in accordance with IG, DOD memorandum, "Management Assertions," October 15, 2003 (Attachment 5), asserting audit readiness of the line or statement which has been validated, using the attached (Attachment 3) assertion letter template,
    - A summary of the validation work performed and an explanation of actions taken by management to resolve deficiencies,
    - Reports resulting from the validation, and
    - The checklist which was completed during the Validation Phase (Attachment 4).
- If the entity prepares an engagement letter or a management representation letter for

3 Attachment 2

IG, DoD, subsequent representation letters should reflect management's assertions in the engagement or representation letters.

- The IG, DoD will receive the assertion package and determine, based on the information in the assertion package, other pertinent knowledge, and Section 1008, whether it will conduct an assessment of the entities line or statement or whether it will bypass the Assessment Phase and proceed to the Audit Phase.
- The IG, DoD will notify the RPS of assertions received, and advise the committee if the assertion letter will result in an assessment or an audit. The IG, DoD will also provide a cost estimate for the assessment or audit. Note: It is IG, DoD's judgment whether to assess or audit.
- The RPS will review improvement plans, representation letters, and IG, DoD recommendations and develop prioritized recommendations for assessment and audit schedules to present to the ESC. The Funding Subcommittee will also review the recommendations of the RPS for funding issues. The recommendations for assessment and audit will be presented to the Financial Management Improvement Plan ESC for approval and prioritization. Recommendations presented to the ESC will address scope limitations that may be imposed on the assessments or audits.
- Entities will be notified when they are approved for assessment or audit.

Assessment Phase

The purpose of the Assessment Phase is to assess the reliability of the line or statement which the entity asserted as being ready for audit. Assessment will generally be done first if a statement has never been audited. Assessment could also occur when the IG, DoD believes circumstances may exist which would cause the entity to obtain an opinion other than unqualified and determines that an assessment is necessary to ensure reliability as required in Section 1008. During the Assessment Phase, an entity may perform remediation in the event a deficiency is identified which would prevent an unqualified opinion.

The assessment will be performed by the IG, DoD or by an Independent Public Accountant (IPA) contracted to perform work for the IG, DoD, after the ESC has approved the assessment. The scope of the assessment will be determined in accordance with the General Accounting Office Financial Audit Manual and will consist of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual. The assessment process will determine whether the entity can likely achieve an unqualified audit opinion. In the event that it is determined that circumstances or problems exist that preclude an unqualified opinion, a report will be written to management that describes what has prevented the auditor from obtaining sufficient, reliable and competent information regarding the reliability of reported information. The report will recommend to management what needs to be accomplished to remedy the problems.

The Assessment Phase will be used as part of the IG, DoD's audit strategy to reduce risks of the unknown and introduce new auditors to the entity's processes.

- Progress will be reviewed and monitored by management and the entity's audit committee through regularly scheduled interim progress reports. Management will inform its OUSD(C) point of contact of any new deficiencies identified. There will be continued communication, both written and oral, as the assessment progresses.
- Management should take actions to correct problems identified during the assessment.

- The IG, DoD will recommend when it is appropriate to move forward with a formal audit.

Audit Phase

The purpose of the Audit Phase is to obtain an auditor's opinion of the condition of an entity's financial statement line or an auditor's opinion on the fairness of the presentation of the information in the financial statements. When a financial statement or portion thereof is asserted to be ready for audit and has passed assessment, or assessment has been waived, the IG, DoD will determine the appropriate scope and nature for financial audit and the associated reports.

During the Audit Phase, the entity and its accounting records will be audited to determine if the balances and related notes presented on its financial statements fairly represent the operations of the entity.

- With the assistance of the IG, DoD, components will prepare detailed engagement letters requesting audit services.
- Components will prepare as many interim management representation letters as necessary which would include any additional assertions to date.
- Components will prepare a final management representation letter.
- Deficiencies will be immediately addressed with a written plan for resolution, including projected resolution date.
- The IG, DoD will intervene if necessary to end the audit and recommend a follow-up assessment upon indication that the audit may not have a favorable outcome.

DRAFT

Financial Improvement Initiative Major Phases*

DISCOVERY AND CORRECTION PHASE

WHY?
- Implement 1008.**
- Discover problems.
- Evaluate solutions.
- Plan solutions.
- Correct processes.
- Complete policy.
- Complement Business Management Modernization Program.

HOW?
- Develop improvement plans.
- Establish audit committees.
- Develop systems strategy.
- Prepare business cases for systems changes.
- Prepare and review full set of financial statements each quarter.

VALIDATION PHASE

WHY?
- Implement 1008.
- Enhance credibility of assertions.

HOW?
- At beginning, coordinate and obtain comment from IG, DoD and notify Review and Prioritization Subcommittee.
- Management documents processes, identifies controls & systems, and ensures auditable universe of transactions & supporting documentation is available.
- Management requests validation of financial information.
- Performed by Internal Review, Component's Audit Agencies, or external audit firm.

ASSERTION

WHY?
- Communicate to IG, DoD and auditors reliability of financial information.

HOW?
- Assertion Letter to IG, DoD.
  - Respond to IG, DoD's instructions.
  - Checklist.
  - Results of validation and reports.
- Agreement with engagement letter and management representative letter, if used.
- Memo to IG, DoD, copy to OUSD(C) Review & Prioritization Subcommittee.
- ESC approval for assessment/audit required before IG, DoD obligates funds for assessment/audit contracts.

ASSESSMENT

WHY?
- Implement 1008.
- Allows remediation.
- Attests to management assertion.
- Plan audit.
- Reduce risk of unknowns (auditor).
- Introduction to organization (auditors).

HOW?
- IG, DoD oversight of IPAs.
- IG, DoD in-house.

AUDIT

WHY?
- Implement CFO Act.
- Implement 1008.
- Presidents' Management Agenda.

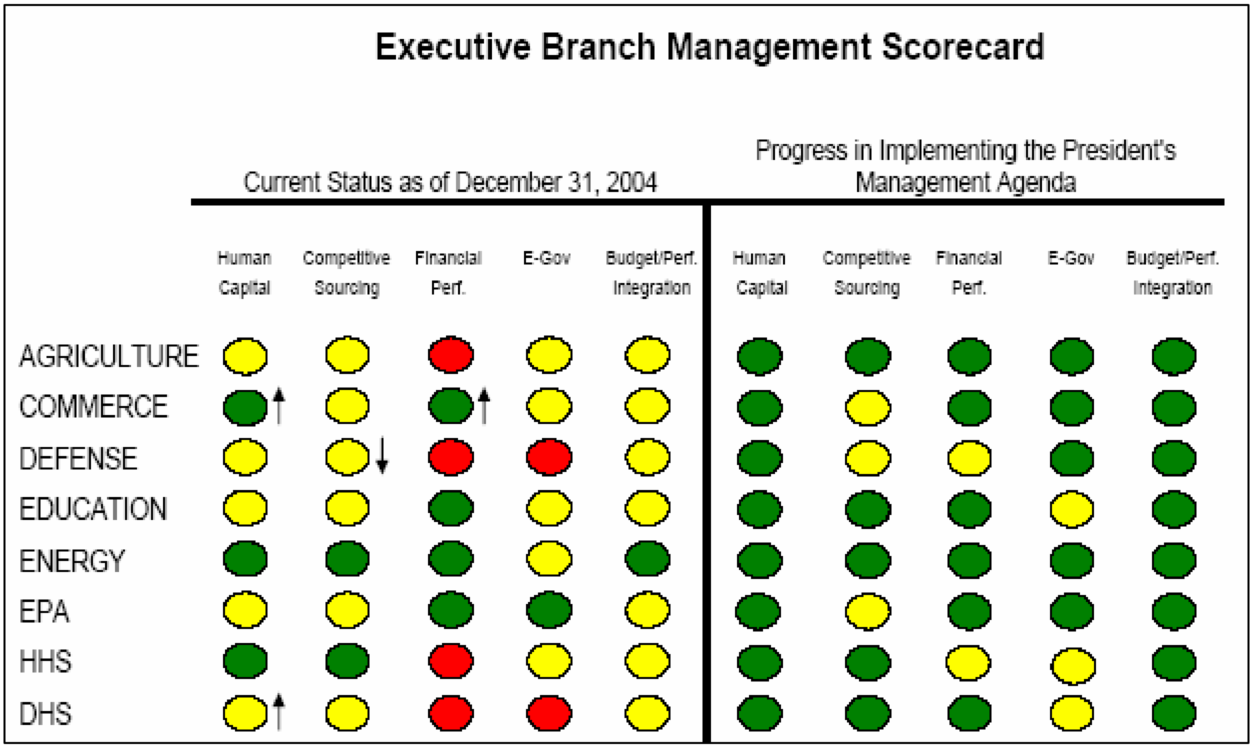
HOW?
- Pass assessment.
- IG, DoD oversight of IPAs.

*Acronyms are explained within the Assertion Process Business Rules
**Fiscal Year 2002 National Defense Authorization Act, Section 1008

Attachment 1

Appendix G. Executive Branch Management Scorecard

This appendix contains the Executive Branch Management Scorecard as of December 31, 2004. This is provided to demonstrate how financial data is made visible all the way to the highest level and underscores the importance of entities being ready. It also reflects the government's commitment to report and assert financial statements information.


Executive Branch Management Scorecard
Current Status as of December 31, 2004
Progress in Implementing the President's Management Agenda
Human Capital
Competitive Sourcing
Financial Perf.
E-Gov
Budget/Perf. Integration
Human Capital
Competitive Sourcing
Financial Perf.
E-Gov
Budget/Perf. Integration
AGRICULTURE
COMMERCE
DEFENSE
EDUCATION
ENERGY
EPA
HHS
DHS

Office of the Under Secretary of Defense (Comptroller) (OUSD(C))

How to Prepare for an Audit of Environmental Liabilities Course

Final Examination

Student Name: ____________________________

Version 1.0 **October 2005**

Prepared by:
Science Applications International Corporation
Southbridge Hotel and Conference Center
14 Mechanic Street, Room C-3100
Southbridge, MA 01550-2570

An Employee-Owned Company

Final Examination

Directions

This is an open-book final examination covering subject matter taught in this course. It will assess your knowledge of the general subject matter and requirements for documentation needed for audits of environmental liabilities. The questions on this examination are multiple-choice, fill in the blank, true/false, and matching. Write in or circle the correct answer or answers to each problem.

Time Allocation

The time allocated to this examination is 40 minutes: 30 minutes for the exercise and 10 minutes for the critique.

Number	Question
1	The general rule for recording a liability is ______________________. a. it must be probable b. it must be measurable c. it must be funded d. Both a and b
2	___________________________ can include estimated amounts for future cleanup of contamination resulting from waste disposal methods, leaks, spills, and other past activities that have created a public health or environmental risk.
3	If an environmental liability is identified after the annual report to Congress, but before the end of the FY, you should disclose it in ________.
4	The first step to determine whether a liability is DERP or non-DERP is to ______________________. a. ask DFAS b. review the DoDFMR, Volume 4, Chapter 12 c. review the activity for a permit requirement d. ask if the event is a DERP eligible event

<table>
<tr><th>Number</th><th>Question</th></tr>
<tr><td>5</td><td>Match each item in the first column to the appropriate selection from the second column.

<table>
<tr><td>___</td><td>To be a probable liability, the first step is to decide if there is a likely contamination based on ____________.</td><td>A. Internal Control</td></tr>
<tr><td>___</td><td>_________________ is a condition, situation, or circumstance involving uncertainty that will be resolved in the future.</td><td>B. Due Care</td></tr>
<tr><td>___</td><td>Where do you recognize environmental liabilities?</td><td>C. Note 14</td></tr>
<tr><td>___</td><td>OMB Circular A-123 relates to ___________________.</td><td>D. Contingent Liabilities</td></tr>
</table>
</td></tr>
<tr><td>6</td><td>Cost estimates are considered _____________________.

a. supporting documentation

b. input transactions

c. environmental liabilities

d. All of the above</td></tr>
<tr><td>7</td><td>To discover whether a liability is an environmental liability, you should _____________________.

a. determine if an event occurred that may require a future outflow of resources to correct, restore, remediate, or close a facility or site

b. determine the likely funding source

c. determine whether the amount of the liability can be estimated

d. All of the above</td></tr>
</table>

Number	Question
8	The organization preparing estimates must retain adequate supporting documentation to identify ____________________. a. data valuation b. estimating methods c. customer's rationale d. DFAS reviews
9	Cost estimates should include all of the following costs except __________. a. LTM b. project management c. all remaining studies d. normal environmental compliance
10	Using an example from you own work, and in your own words, describe an audit trail. ____ ____ ____ ____
11	Auditors will only accept paper documentation as evidential matter. a. True b. False
12	A person serving as an audit liaison/POC should be able to ____________. a. provide information or evidential matter b. develop cost estimates c. explain departures from normal procedures d. Both a and c

Number	Question
13	Who can perform the review that must be accomplished during the Validation Phase? a. management b. internal auditors c. independent public auditors d. All of the above
14	The ____________________________ states that sufficient audit-ready evidential matter is available as well as knowledgeable staff to support an audit.